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## Gizza better job

The composition of the UK's labour market has gone through some dramatic changes recently. Immigration, particularly from Eastern Europe, has been one important component of this transformation. But changes to the age structure and the quality of UK workers' jobs are having an even greater impact. In this issue of *Fundamentals* Julien Garran, LGIM's head of asset allocation, argues that together with trends in the global economy, these changes are all positive for the UK's service sector.

**B**ack in 2003 Mervyn King, the Governor of the Bank of England, pointed out that things had been very 'nice' in the UK over the previous ten years or so. Not normally one to use such bland terms to describe the world, Mr King went on to explain that he meant that the UK economy had gone through a period of **Non-Inflationary Consistent Expansion**. Which has indeed been n.i.c.e. for us all.

This period of low inflation with strong, consistent growth originally had its roots in some important factors. These included the very low commodity prices of the mid to late 1990s; the rise in sterling; and the increased participation of the Chinese labour force in the global economy. Together these factors meant that the strong growth that we experienced over this period did not translate into excess demand for labour, which would normally lead to higher wage inflation, and the inevitable slowing of growth as interest rates rose as the authorities tried to get inflation back under control again.

But another factor in this performance was the change in the composition of the UK's labour force. Between 1993 and 2004 female participation in the labour force rose by over 1.5 million, expanding

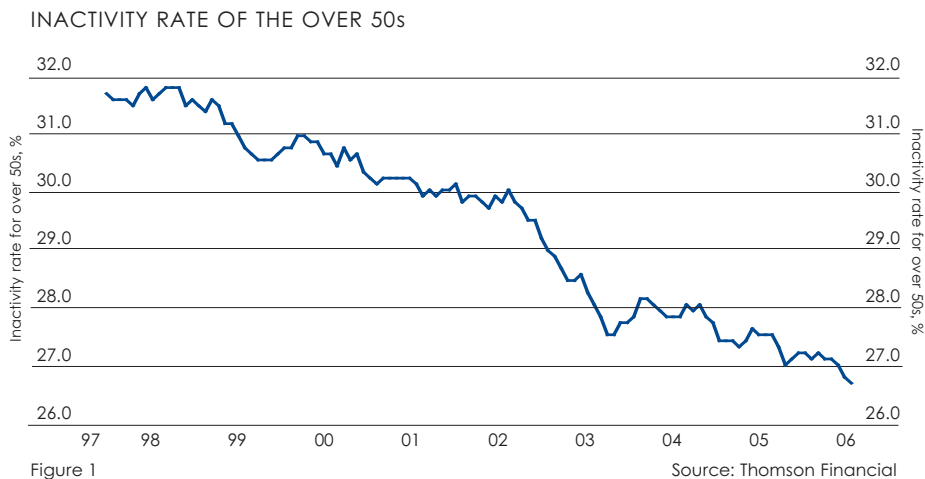
the pool of available labour, which in turn helped to contain inflationary pressures that might otherwise have built up.

Although female participation in the UK's labour market remains high, the continued low inflationary expansion of the UK economy now has more to do with net migration in recent years. But it is not just net migration that has helped boost the labour supply over the last couple of years; the age profile of the UK's labour force is changing too. The composition of global growth is also changing.

As well as affecting the UK's macroeconomic performance, these changes have implications for future consumption patterns, and therefore have potentially important investment implications too. In this issue of *Fundamentals* we explore these developments.

### Anyone need a plumber?

Four to five years ago, anyone living in London and the South East was familiar with stories about hourly rates charged by some tradesman that would have made a corporate lawyer blush. There was no doubt that after a period of strong growth that there were skill shortages in certain key areas, particularly in the building trade. However, the UK's enlightened approach to the EU's recent enlargement, which



enabled workers from the new accession countries to work in Britain, has helped to alleviate these skill shortages – and average plumbing bills!

Recent home office figures showed that 447,000 workers from the eight new EU states successfully applied for work between May 2004 and June this year. In addition, the Home Office said that this number probably rose to 600,000 when self employed builders were included in the figures. The now common stereotype of the “Polish plumber” is not without basis. The Home Office estimated that 62% of the Eastern European boost to the UK’s labour supply is from Poland – though of course they are not all plumbers! It is estimated that 56% of the total influx of workers work in UK factories.

As with previous periods of net migration to the UK the average migrants are relatively young. 82% of the East European workers are aged between 18 to 34. And they have come to Britain with relatively few dependents, given their age profile. Of the 447,000 that have successfully applied for work the Home Office estimate that they have brought with them only 36,000 dependents.

However, unlike previous periods of net migration to Britain, East European workers have filled job vacancies across the country rather than in specific areas. For example, East Anglia is estimated to have the highest proportion of East European migrants at the moment. Arguably this wider dispersion has helped

to spread out the transitional costs, and burdens on public services.

Increased immigration (not just from Eastern Europe, but from elsewhere too) has boosted UK output and helped extend the UK’s N.I.C.E. period, which is nice!

### When I’m 64

Although the Polish plumber and his colleagues have grabbed most press attention in terms of their impact upon the UK, another important change has been underway too. This is the rise in the participation of older workers in the UK’s workforce and the fall in the participation of younger UK citizens.

Figure 1 shows the first of these phenomena. Older workers have been playing a larger and larger role in the UK’s workforce since 1998, but the trend has accelerated significantly since 2002. The inactivity rate in this age group has fallen by more than 2.0% since that time.

Inactivity is defined as not being available for work. There could be a variety of reasons for this, long-term sickness, retirement etc. However, recent Office for National Statistics (ONS) data shows that over the last year only one category of inactivity has risen. This category relates to those people that have ‘chosen’ to be economically inactive because they have stayed on in education – i.e. predominantly young people.

This is an interesting phenomenon. Although many migrant workers are highly skilled and are filling teaching posts etc,

most migrants from Eastern Europe are doing unskilled work, even if they are skilled themselves. The UK’s younger population seems to be responding to this increased competition from migrant workers (and older UK workers too) by staying on longer in education, presumably aiming for better paid jobs in the future. The government has encouraged this process by introducing cash incentives – ‘Education Maintenance Allowances’ – to students who stay in education after 16. Together, these factors explain why the activity rate of 16-17 year olds has collapsed in recent years down from 52.5% in 2004 to currently 46.5%.

Despite this, the UK’s labour supply as a whole has risen by 1.7% over the past year, thanks to rising migration and increased participation among the over 50s. This represents the biggest rise in the active labour supply in over two decades.

### What sort of jobs?

As well as experiencing a rapid change in the make up of the labour force, the types of jobs that UK workers are doing is changing too. Over the past year, jobs have been lost in relatively low paid sectors of the economy like consumer services (i.e. retail) and the public sector, while jobs have been created in higher paid sectors of the economy like business services.

Figure 2 shows an interesting change in the types of jobs being created and lost over the past ten years. The red line shows the average salary earned by a worker in a sector where a job has been lost. The blue line shows the equivalent figure, but for the average salary in a sector where a new job has been created.

For most of this period job losses have been in higher paid sectors of the economy – notably the manufacturing sector, whereas new jobs have been created in lower paid parts of the economy – largely public sector jobs.

However, Figure 2 also shows that the trend since 2004 is for new jobs created in higher paying sectors of the economy, whereas job losses have been increasingly concentrated

in lower paying sectors. The figure also shows that for the first time in ten years the average salary of new jobs is now higher than for those jobs that have been lost.

So, the most important development in the UK labour force is that UK workers are upgrading their jobs.

### Service sector outlook

Most economists agree that the increase in the labour supply and the change in the domestic composition of the labour force have together had a beneficial impact upon the economy as a whole. But the recent rise in unemployment from 4.7% a year ago to 5.5% today reminds us that at any point in time, relatively speaking, there are winners and losers.

In our view it is arguably Britain's white collar workers that have been the chief beneficiaries of these recent developments. The increase in skilled manual labour in particular from Eastern Europe has reduced the price of many of the services that they consume – plumbing services being just one of many.

We believe that these developments are all very positive for the UK's service sector. This is because white collar workers tend to consume more service sector products, such as those provided by banking, media, health and financial services companies.

We can see how spending preferences change as people become wealthier in Figure 3. The blue bars represent the amount spent per week by UK households on insurance products by income decile, where 1 is the lowest income decile and 10 the highest. The red bars show spending per week on other life and pensions products. Not surprisingly the weekly spend on these services rises exponentially as incomes rise. Households in the bottom income decile on average spend under £7 per week on these services, whereas those in the top decile spend almost £100 per week.

Wealthier households also tend to hold more investment products like ISAs. Only

AVERAGE SALARY OF JOBS CREATED AND LOST

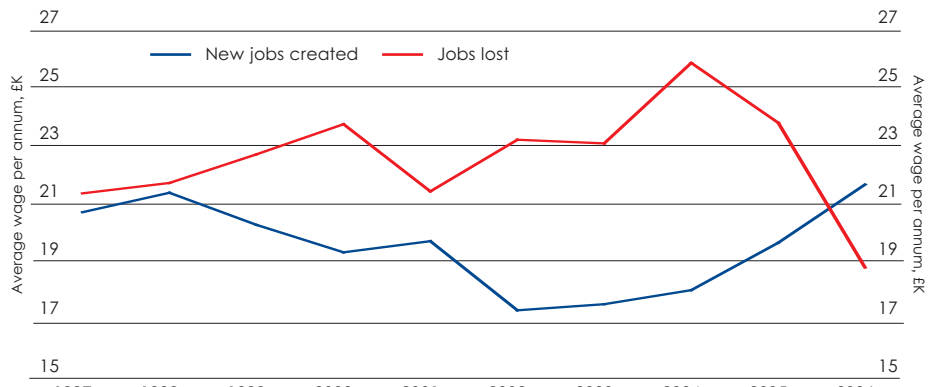


Figure 2

Source: LGIM Research

16% of UK households with incomes between £100 and £200 per week have ISAs, while 53% of those with weekly incomes greater than £1,000 per week have ISAs.

This is good news for the business sectors of the economy that provide these services, particularly since, as Figure 2 shows, more Britons are becoming white collar workers as Eastern European labour is providing more of the blue collar labour force.

Furthermore, as Figure 1 shows, the over 50s are an expanding part of the UK's workforce. Other things being equal, this section of the population also tends to spend more on service sector products than on those produced by the goods sector.

### Global trends

The UK's service sector will benefit then from the change in the composition of the labour force. And this positive domestic backdrop for the service sector is currently being reinforced by changes to trends in the mix of world growth.

Following the collapse of the high tech bubble in 2000, emerging economies like China were growing faster than developed countries, particularly Japan and continental Europe. One consequence of this was that each unit, or dollar, of extra growth over this period tended to be paid to workers on lower average incomes.

This change in the source of growth created more resource intensive global activity. This is because, for example, investment in developing world infrastructure is more resource intensive than investment in say software, or in other service orientated activities in the developed world. In addition, the sort of product that someone from the developing world would be willing to buy with an extra dollar of income would be very different than the sort of product that someone in the developed world would buy with an additional dollar. The former would buy more resource intensive products, a washing machine or a television for example, whereas developed world citizens would be more likely to buy service

UK HOUSEHOLD SPENDING ON FINANCIAL SERVICES

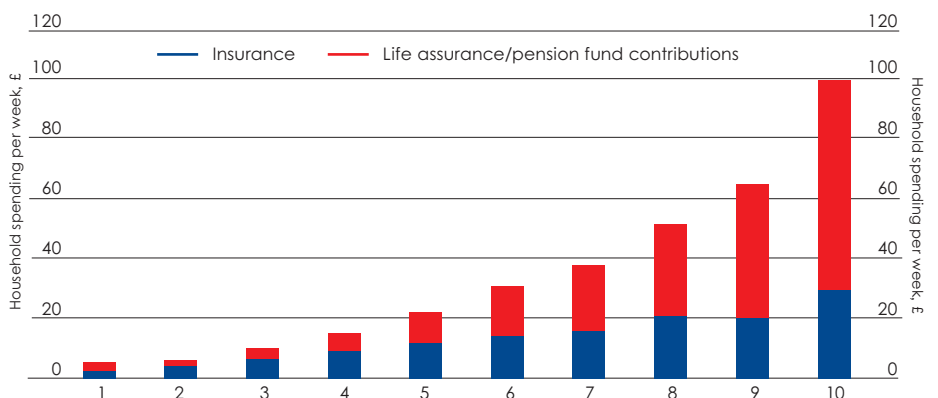
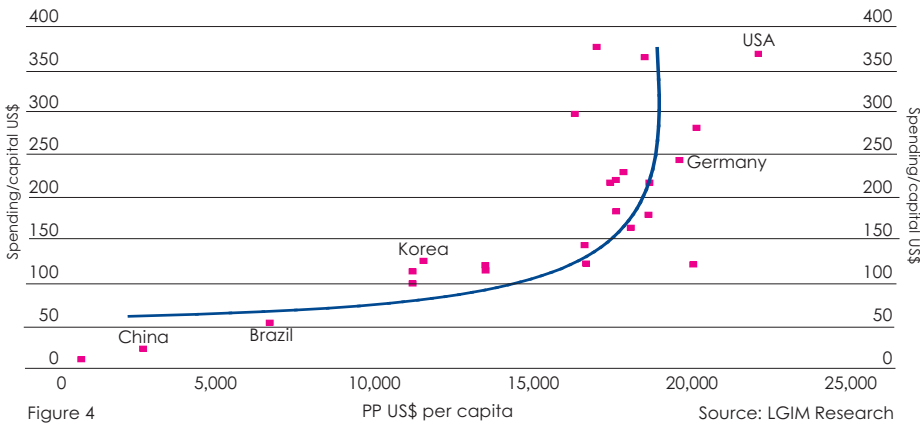


Figure 3

Source: LGIM Research, National Statistics

ADVERTISING SPEND AND PER CAPITA INCOME



sector products – extra healthcare, financial services, media-related products etc.

In Figure 4 we have presented just one example of how spending patterns change as nations become wealthier. Each square on the figure shows the combination of average income per head (on the horizontal scale) and the associated expenditure on advertising (on the vertical scale) for a range of countries. The blue line in Figure 4 therefore shows the average relationship between advertising spend and per capita income. Countries with high per capita income spend much more on this particular service industry than countries like China with much lower income per head of population. The pattern shown in Figure 4 is similar for other service sector related activities too, which is perhaps not surprising.

Global growth leadership is now changing hands. The recent decline in energy and other commodity prices should boost real incomes in the developed world, particularly in the USA where fuel consumption is the highest, which should help boost activity there. Furthermore, over the last two years the global cost of capital has risen with the trend in higher interest rates. In our view developed world service sector companies are probably better placed to deal with this rise in the cost of capital than many low margin, high volume developing world manufacturers.

We have tried to capture the change in the growth environment over time, by using IMF data on over 200 countries to calculate the average wage of a worker that is

associated with global growth. This indicator is presented in Figure 5.

The figure shows that in 1999 the countries responsible for global growth had annual per capita income of around \$19,500 (at 2005 prices). This is because the USA, Europe and Japan were the clear growth leaders at this point. However, we can see clearly how that changed following the collapse of the high tech bubble. By January 2001 the countries largely responsible for global growth had annual per capita incomes of less than \$12,500. But the figure shows how this situation is changing once again. Today the countries generating global growth have annual per capita incomes of just under \$16,500. At a global level then each dollar of additional growth is more likely to be spent on service sector products than on goods going forward.

Summary

The global growth backdrop looks positive for service sector industries. However, within the world's service sector, we believe that the UK's service sector is particularly well placed to benefit from this backdrop, given the changes that are going on in the UK's labour market.

In particular UK white collar workers are getting better jobs. Which is undeniably positive for the UK's service sector. However, service sector trends elsewhere are not necessarily so supportive. For example, in Germany the government is reducing unemployment benefits and cutting social security contributions in an attempt to boost low-paid work and to reduce youth unemployment, and their economy is largely closed to the influence of workers from the new EU states.

One might conclude that the UK's economy and its service sector in particular, is currently 'Poles apart' from its competitors!



Julien Garran  
Head of Asset Allocation

GDP PER CAPITA OF THE AVERAGE PERSON EARNING AN EXTRA US\$

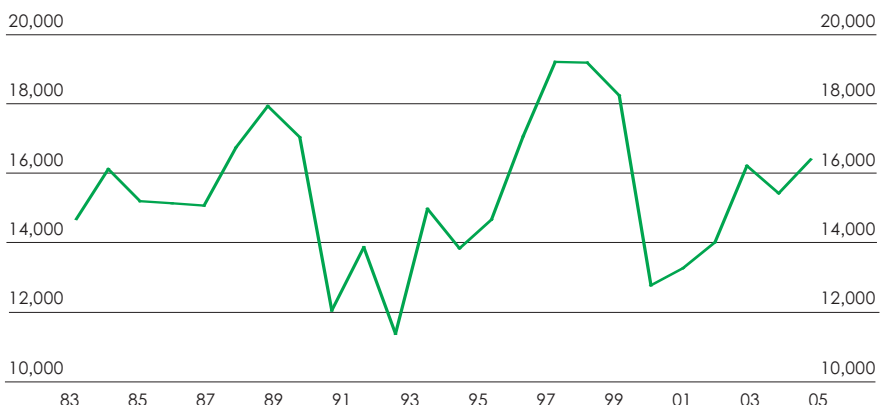


Figure 5

Source: LGIM Research

## Market Overview

# The 6,000 barrier

May 15 now seems a long time ago. At the time of writing the FTSE 100 is trading well above the 6,000 barrier. Most developed world equity markets have more than recovered from May's set back, when investors took fright at the prospect of significant Fed rate tightening. Yet despite breaking through the 6,000 barrier once again, we still feel that UK equities offer relatively good value for money.

The dividend yield on the UK market is still high relative to other markets and therefore its equities continue to look attractive to yield hungry overseas investors. Furthermore, dividend cover for the market is at a multi year high, which further supports the case for UK equities as a value play. Meanwhile, we believe that the recent fall in energy prices will help to boost real consumer incomes in the UK (and in the US), which means that future earnings prospects are not as bleak as was being assumed earlier this year. Furthermore, given that the real earnings yield on the UK market is still over 4.0%, UK equities remain firmly in the sights of cash-rich private equity funds.

Perhaps another way of looking at the value in the UK's equity index is to calculate its 'real value'. For example, the FTSE 100 first broke through the 6,000 barrier back in April 1998. If we deflate equity prices using an index of consumer prices, today the FTSE 100 is more than 1,000 points lower today in real terms compared with April 1998 prices.

There are always downside risks too. Arguably the biggest threat to the market is the prospect for commodities-related stocks. Given their weight in UK equity indices, a sharp fall in the prices of companies in the mining and oil and gas sectors would act as a drag on the market as a whole. However, this risk aside, we still feel optimistic about current UK equity market valuations.

## London

### November rate hike priced in

The UK economy remains robust. The Purchasing Manager's Index (PMI) activity surveys eased somewhat over the third quarter but remain at elevated levels. Consumer trends also remain positive as news from the labour market improved somewhat – unemployment was shown to have fallen for two months and wage growth remained solid. Inflation remains above the MPC's target, but rates were left unchanged at the September meeting. The data was not deemed to have changed sufficiently to warrant a move after the August hike. That said, with inflation likely to be above the MPC's latest forecast through the third quarter, markets continue to expect a 0.25% rate hike in November.

The UK equity market continued to make good progress in September posting a total return of 1.6%, meaning a total return year to date of exactly 10%. The blue chip FTSE 100 index continued to be outpaced by the Mid and SmallCap areas of the market, continuing the theme seen for most of the year. Resources stocks were sold off by investors as commodity prices, and the oil price in particular, continued to come under pressure. News on corporate profits was mixed with positive news from companies such as Carnival, Next and Morrison Supermarkets in contrast to disappointments from Tomkins, British Energy and CSR. Corporate activity picked up again after a brief summer lull, with bid approaches for J Laing, Stanley Leisure and Countrywide among others. 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

### Consumers to benefit from falling gasoline prices

Activity indicators in the US continue to weaken. The Institute of Supply Management (ISM) surveys dropped sharply in September, although the fall in the headline indices masked underlying strength in some of the forward looking components of the survey. Meanwhile housing-related data remains soft. However, oil and gasoline prices have continued to fall, as have borrowing costs as US Treasury yields fell sharply during September. These factors should boost disposable income, thereby easing pressure on consumers during the fourth quarter. Money markets currently expect the next move in US rates to be down, but the Federal Reserve remain vigilant to inflationary pressure and a consumption boost would likely prompt a further hike in the coming months.

The S&P 500 was up 2.5% over the month of September. The consumer discretionary sector posted the strongest gains as declining energy prices and positive store sales data triggered a rotation into the retailers. The Energy sector materially underperformed the broader market as plentiful inventories and slowing global growth caused a more than 10% decline in crude oil prices. Equities and bonds have rallied sharply in response to an easing of inflation and policy concerns. A consortium of private equity buyers acquired Freescale Semiconductor for \$16 billion. The drug retailers were negatively impacted by Wal-Mart's decision to aggressively discount some generic drugs. With third quarter earnings season nearly upon us, the market will be focused on management comments about the coming fiscal year.

## Europe

### ECB hike despite lower inflation

Eurozone economic indicators have continued to come off their recent highs. The Purchasing Manager's Index (PMI) activity surveys weakened throughout the third quarter while regional business confidence surveys continued to show weak expectations. Inflation has eased recently, but remains above the ECB's 2% ceiling. With some signs that German consumption may pick up towards the end of the year ahead of January's planned VAT hike, the ECB remain vigilant to inflationary risks. The decision to raise rates at the October meeting is likely to be followed by a further hike in December.

The Europe-wide index rose by 1.8% through September, continuing the strength through August. The German DAX returned 2.5% over the month, compared with a 1.7% return from the French CAC index. Engineering and Real Estate were the leading sectors, rallying from a disappointing month. The worst performing sectors were Mining and Oil & Gas, where easing commodity prices affected stock performance. More generally, European market sentiment remains vulnerable to the strength of the currency, as exporters are key to European indices.

## Japan

### Koizumi – a hard act to follow

The appointment of new Prime Minister Abe has been taken positively by the market. He inherits a Japanese economy experiencing its longest period of economic growth since World War II, emerging from deflation and with the banking sector now officially returned to health. Certainly former PM Junichiro Koizumi will be a hard act to follow. The market is reassured by the steps Mr Abe has so far taken to strengthen ties with China and South Korea. He is also keen to ensure that Japan remains on a growth track, so is unlikely to raise consumption tax any time soon, and is in fact talking about reducing corporate tax.

Blue chip exporters have led the market in recent weeks. The business environment remains relatively stable while the yen's weakness against both the euro and dollar means many will need to revise estimates upwards. Already we have seen revisions from Nintendo and Toyota.

## Pacific Basin

### A balanced outlook

In September the FTSE AW Pacific (ex-Japan) rose 3.7% in sterling terms. Falling oil prices and lower US Treasury bond yields have raised expectations that the US can avoid a consumer recession.

The Philippines was the best performer up 13.9%, with India up 9.5%. Lower oil prices not only help ease the Philippines' fiscal deficit but boost domestic consumption and corporate profit margins. India's economy continues to grow steadily with GDP up 8.9% year-on-year in the quarter ending June 2006. Australia was a laggard – unchanged on the month – hit by the 7% fall in Commodity prices. Thailand was up just 1.2% with the main event being the unexpected bloodless coup, ousting Prime Minister Thaksin Shinawatra.

The next hurdle for Asian stock markets is the successful listing of the Industrial and Commercial Bank of China (ICBC) which is the largest bank in China.

The outlook remains a finely balanced one with the region faced with the uncertain impact of a slowing US economy and a Chinese economy set on a lower but sustainable growth profile. This needs to be set against corporate balance sheet strength, strong cash flow and historically high levels of profitability. Domestic consumption is expected to remain resilient and governments have the capacity to accelerate expenditure on infrastructure if required. Liquidity remains abundant and corporate activity is expected to remain at current high levels.

MAJOR EQUITY MARKETS – TOTAL RETURNS £ 2005/2006

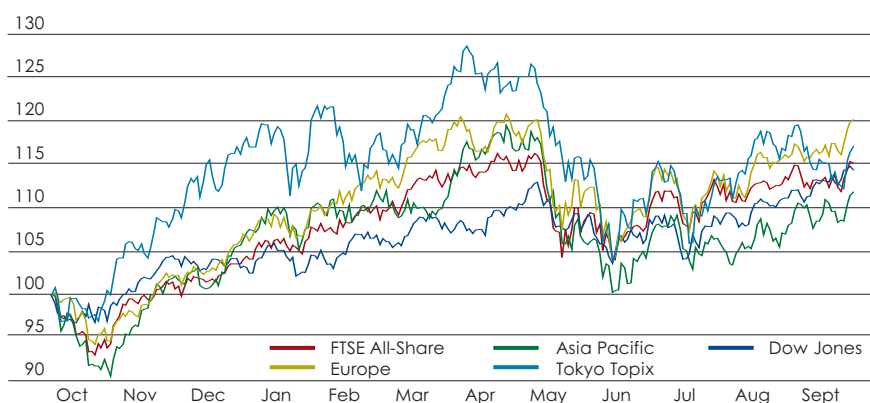


Figure 1

Source: Datastream

Past performance is not a guide to future performance

# Snapshot

## Global PMIs and Interest Rates

Expectations of global growth have declined recently as a range of forward looking indicators have deteriorated through the summer. In particular, the Purchasing Manager’s Surveys of business activity have weakened. The table below shows how sentiment has changed across sectors and regions.

The weakness in sentiment has been driven by the service sector, particularly in the US and Europe. This reflects concerns about a US consumer slowdown as data on the US housing market has steadily weakened. In Europe, persistent weakness in the labour markets is depressing service sector sentiment. Globally, while service sector sentiment may be leading the decline, manufacturing sentiment has also weakened on concerns that slower global growth will depress export demand.

### REGIONAL PMI SURVEYS

	June 2006		September 2006		Change	
	Manufacturing	Services	Manufacturing	Services	Manufacturing	Services
US	53.8	57.0	52.9	52.9	-0.9	-4.1
UK	55.1	58.7	54.4	57.0	-0.7	-1.7
Europe	57.7	60.7	56.6	56.7	-1.1	-4.0
Japan	54.3	N/A	54.8	N/A	0.5	N/A

Figure 1

Source: Bloomberg

Unsurprisingly, these falls in global activity indicators, while they remain in expansionary territory, have led money market participants to price in the peak in their interest rate expectations. The next move in the US is expected to be a cut, while the UK and Europe have just one rate hike each priced in before remaining on hold.

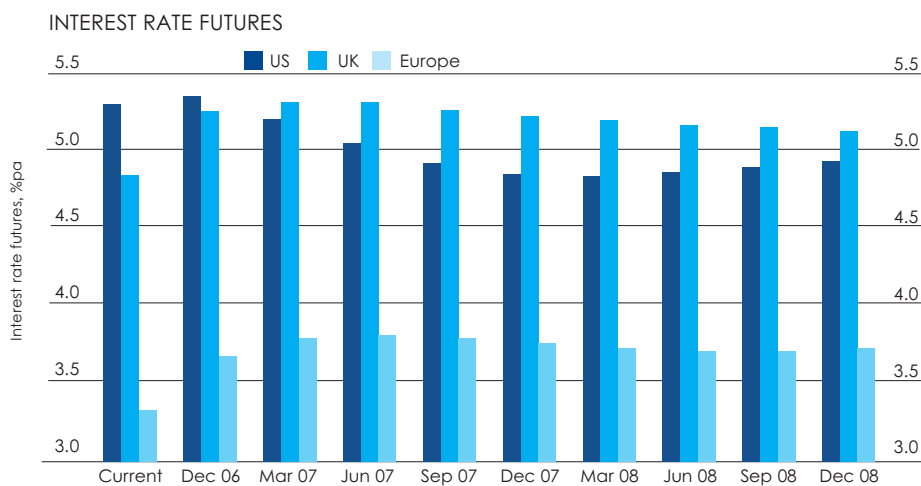


Figure 2

Source: Bloomberg

In the short run, we believe markets are underestimating the degree of tightening required in the US. We highlighted last month that US consumption is likely to accelerate in the coming months as lower gasoline and borrowing costs boost household income. This is not reflected in the PMI surveys however, which tend to be more backward looking. We would tend to agree with the market expectations for Europe and the UK. In Europe, the ECB are unlikely to want to push interest rates much beyond 3.5%, given the still weak regional consumption trends and the strength of the currency. While in the UK, the near-term strength of inflation and the housing market means a further hike this year is very likely.

## Views Commentary

## FTSE expectations revised down while uncertainty measures narrow

	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	-	-	1.90	2.70	14.50	6.20	4.50	4.60	5.00	5.00	1.84	1.89	0.68	0.67	6400
CSFB	3.30	2.50	3.10	2.60	7.40	5.00	4.85	5.00	5.00	5.25	1.87	1.81	0.67	0.66	6150
Deutsche Bank	2.30	2.40	2.70	2.40	16.10	7.70	4.70	4.60	5.00	5.00	1.88	1.86	0.69	0.72	6100
Goldman Sachs	3.40	2.40	2.80	2.40	12.90	8.80	4.80	4.50	4.75	4.75	1.87	1.87	0.67	0.70	6015
HSBC Securities	3.30	2.30	2.70	1.50	9.00	6.00	4.40	4.20	5.00	4.50	1.89	1.92	0.69	0.75	6350
JP Morgan	3.20	2.40	2.60	2.80	-	-	4.50	4.70	5.00	5.00	1.83	1.94	0.69	0.69	-
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	-	-	2.80	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	3.40	2.40	2.50	2.50	8.00	6.00	5.00	5.30	5.00	5.00	1.82	1.71	0.68	0.70	6150
UBS	3.50	2.80	2.60	2.60	15.00	10.00	4.85	4.65	5.00	5.00	1.98	1.96	0.68	0.69	-
Median (ex L&G Inv Mgt)	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
Last Month	3.25	2.45	2.70	2.50	12.90	7.25	4.80	4.55	5.00	5.00	1.84	1.84	0.70	0.71	6300
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.

Respondents to our survey this month remained positive on the prospects for the UK economy. The economy is expected to grow by 2.7% this year, slightly above trend, with a solid 2.6% growth expected for 2007. Inflation expectations for the current year are slightly higher than last month at 3.35% and respondents continue to expect one further rate hike from the MPC this year, staying on hold through 2007. In the currency markets, sterling is expected to remain broadly unchanged against the dollar but to steadily weaken against the euro.

In light of the robust growth expectations, equity earnings growth expectations remain solid at 12.65% for 2006, but 2007 expectations have been revised down to 6.45%. The median expectation for the level of the FTSE at the end of the year is a touch lower than last month at 6150, though the bull-bear gap has narrowed from 655 index points to just 385. According to median expectations, gilt yields will end the year at 4.7% and fall to 4.6% in 2007.

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