



I N V E S T M E N T V I E W S

No. 8 of 2007

AUGUST 2007

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GENERAL COMMENT

YOU CAN'T MAKE A SILK PURSE OUT OF A SOW'S EAR

For some months we have been expressing concern about the destabilising potential of the sharp contraction of activity in the American home market, not least because of the reckless way in which the boom was financed in its latter years. There are unlikely to be any savvy observers who are not now familiar with the terms "sub-prime loans" and "CDOs", even if the detail of the latter remains hazy. A deep understanding is unnecessary, however, to comprehend the potential implications at a broader level. The essential fact is that poor quality loans, providing illusory rates of return, have been repackaged in clever ways (sliced and diced as they say) so as to create parcels of higher rated paper - the proverbial silk purses from sow's ears. The trick was based on the notion that the riskiest components of these baskets would fail first, while the best would be safe enough to justify a BB rating. Not being financial rocket scientists the conceptual arithmetic is beyond us but we have suspected that this comprehension difficulty also applies to a lot of the people who have been seduced into buying the stuff. Now this may be an unfair observation, and it may be that pension fund trustees and their managers all have such advanced

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degrees, but we doubt it. Of course, all new paradigms (remember that term?) are - to mix a couple of metaphors - great gravy trains so long as the music doesn't stop. Unfortunately when it does there is more than a sniff of a Tontine to them. Whatever the truth, the reality is that some of the owners of this paper have leveraged up their portfolios to extract even higher rates of return and, finding themselves under redemption pressure, have not unsurprisingly wished to reduce or remove exposure. This is, of course, easier said than done, since the valuations that had given comfort now turn out to have been generated by computer models rather than by transactions in a liquid secondary market. Indeed the gulf between the price buyers have been prepared to pay in a fire sale and theoretical values has collapsed by up to 60% in a matter of weeks. This is bad enough if you haven't borrowed to buy them but if you have - and gearing of 5 to 20 times has not been uncommon with certain of the hotter funds - this sort of fall wipes you out, possibly several times over.

On the principal that the investor can only be wiped out by 100%, it follows that someone else has to carry the can, and this may be the prime broker, or the bank (often the same) or the sponsor. The end result is the same - liquidity destruction. If this was only a fringe activity no-one would mind but the nominal amount of CDOs in issuance has been estimated at USD900 billion. While this is a large number indeed, most of these instruments will eventually return what was expected, while some, possibly an uncomfortable proportion, will end up worthless.

This is not all. The sub-prime problems in the US may be spreading up the quality curve. Countrywide Financial, the US's largest mortgage lender, has warned that problems with its sub-prime portfolio had spread to its prime book, triggering a five-fold increase in bad debt provisioning. The CEO actually said that the housing market was in its worst state since the Great Depression. Some of the problem stems from the expiry of teaser lending rates and the inability of borrowers to re-finance either because of impaired collateral value or higher long term rates or both. Fitch, the ratings agency, reckons that USD 700 billion of re-financing will be necessary in the next three years. Many will be unable to accomplish this and the housing market could remain a drag for quite a long time. If we assume a relatively pessimistic case that 25% of all sub-prime and Alt-A (the next higher level in risk) debt were to go bad, it would represent an event of roughly the same magnitude in real terms as the S&L crisis of the late 1980s.

On its own, this might result in a general tightening of lending standards but little more because the banks are far stronger than they were in the late '80s. However, banks are now getting hit in another way. Having guaranteed the huge borrowings for agreed private equity deals they assumed easy credit conditions would allow them to syndicate it all out for the usual fat fee to willing buyers. Unfortunately for them this happy state of affairs has ground to halt because the proverbial train stopped after the loans were guaranteed but before they were syndicated. Needless to say, the private equity people have shown little sympathy as it is not their problem. It has been estimated that around \$500 billion of such loans are in the pipeline for syndication on deals which have already been agreed. No doubt, most of this will eventually get passed on when nerves steady, even if the banks have to shave or

forego their fees, but for the moment they remain on their books, either by choice in the case of the highest quality tranches, or by default. Much of the recent financing for the buy-outs of Alliance Boots and Chrysler remains with the banks and while no-one will dispute their credit-worthiness (well, Alliance Boots anyway) that is not really the point right now because the market has ceased to operate sensibly. Right now, the risk to markets is not in valuations nor, provided the housing issue does not send the US into recession (a low probability eventuality), from global economic slowdown. Companies, particularly large ones, are cashed up and balance sheets are in vastly better condition than they were a few years ago. Many big companies can finance expansion with free cash flow. It is certainly very likely that private equity will be dead in the water for some time, and this will take away some merger and acquisition activity, but corporate buy-backs will continue so long as equity is perceived to give a positive carry on cash even if it may be harder or costlier to borrow for this purpose. Nor is there any great risk of a setback in consumer demand, since economic growth should continue and wages will keep on rising. The problem will come if liquidity contraction, as a result of investor flight to cash to reduce gearing, brings about forced selling of shares. In such circumstances valuation and prospects will be secondary considerations to the need to raise money.

THEY SAID IT THIS MONTH

Boris Johnson, the high profile loose cannon of a Tory MP, is the likely Conservative candidate to oppose Ken Livingston in the next May's election for Mayor of London. With contenders like these the election should be worth watching. Amongst Boris's better quotes have been the following.

After being sacked from the Conservative front bench by Michael Howard

"My friends, as I have discovered myself, there are no disasters, only opportunities. And, indeed, opportunities for fresh disasters."

On Tony Blair

"He is a mixture of Harry Houdini and a greased piglet. He is barely human in his elusiveness. Nailing Blair is like trying to pin jelly to a wall."

On school food

"If I was in charge, I would get rid of Jamie Oliver and tell people to eat what they liked."

Ahead of the Olympic Games next year the Chinese government, according to Private Eye, is brushing up on English translations for such things as menus and road signs. We will be sad to see the end of items such as 'fried crap' and 'Big Bowl Fresh immerse Miscellaneous Germ', and the wet floor sign reading 'To take notice of safe: The slippery very crafty'. Also to go is the sign 'Racist Park' on a meeting place

for ethnic minorities, and signs on handicapped toilets saying 'deformed men'.

Also this month we have found some nice neologisms

"Coffee - the person upon whom one coughs"

"Willy-nilly - impotent"

"Flabbergasted - appalled over how much weight you have gained"

"Lymph - to walk with a lisp."

For Nic's golfing corner this month we have two more little stories

Police are called to an apartment and find a woman holding a bloody 5-iron standing over a lifeless man. The detective asks, "Ma'am, is that your husband?" "Yes" says the woman. "Did you hit him with that golf club?" "Yes, yes, I did." The woman begins to sob, drops the club, and puts her hands on her face. "How many times did you hit him?" "I don't know, five, six, maybe seven.....just put me down for a five."

A young man and a priest are playing together. At a short par-3 the priest asks, "What are you going to use on this hole my son?" The young man says, "An 8-iron, father. How about you?" The priest says, "I'm going to hit a soft seven and pray." The young man hits his 8-iron and puts the ball on the green. The priest tops his 7-iron and dribbles the ball out a few yards. The young man says, "I don't know about you father, but in my church when we pray we keep our head down."



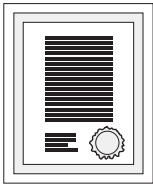
CURRENCIES

Two themes have dominated in currency markets this month. Firstly the weakness in the US dollar has continued and secondly the two strongest currencies have been the carry trade favourites, the yen and the Swiss franc. Both these themes have been directly related to the widely publicized problems in the credit markets and, for once, fundamental economic news, some of which is commented on in the bond section, has not played any great part in currency movements.

The weakness in the dollar, in part, relates to fears that the sub prime mortgage crisis and its attendant woes will lead to a further slowing in the US economy. This would mean that the Fed could be tempted to cut interest rates earlier than previously anticipated in order to give a boost to growth and to negate the possibility of a full blown financial crisis developing (although it is by no means certain that Bernanke will behave in the same way as his predecessor and flood the market with liquidity whenever trouble threatens - the so called Greenspan put). The markets over the last two weeks have moved from pricing in one interest rate cut in twelve months time to more than two.

As far as the yen, and its partner in crime, the Swiss franc, are concerned, we have rabbitied on for many months about the activities of Mrs. Watanabe and others who have been funding from yen to invest in higher yielding assets and what might happen when the music stops. The credit alarms in July, if not yet bringing the music to a complete halt, at the least created a significant pause as some investors decided to cash in their chips. The yen, being bought back in these circumstances, responded by being the strongest major currency during the month with a rise of 3.7% against the dollar whilst the second strongest was the Swiss franc, up 1.8%. The currencies benefiting least from the dollar weakness were the high yielders, the Australian dollar, the New Zealand dollar and sterling. Indeed a yen investor holding Australian dollars saw the exchange rate move against him by over 5% in a matter of a few days, sufficient to wipe out the best part of a year's interest rate differential. In the case of the New Zealand dollar the change was even more extreme.

As the credit problems have continued, or even intensified, into the early days of August, so the same broad currency patterns have persisted. This is hardly surprising but it does mean that, until the credit markets have settled down, we should expect to see a continuation of the risk reduction process which has led to the movements we describe this month. For the time being economic numbers may continue to take a back seat.



BONDS

July was a much better month for the bond markets and they managed to recoup some of the losses of the last few months. Over the period yields fell 0.26% in the US, 0.21% in the UK, 0.24% in Germany, 0.22% in Australia and 0.07% in Japan. Although these are quite sharp moves in yields, this has merely brought them back to where they were trading in mid May.

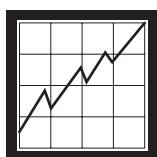
The falls in yields have been triggered by the deteriorating conditions in the credit markets. Last month we highlighted the problems stemming from the mortgage markets in the US and this has now spread across into other credit instruments such as the corporate loans and debt markets. Throughout the loans markets, stresses and strains are beginning to appear. Only a few weeks ago investors were falling over themselves to gain access to issues, whereas today similar paper is shunned. This has caused the private equity buyout market to come to a juddering halt and the banks have been left with a large overhang of paper amounting to some \$170bn in Europe alone. The music has firmly stopped in this particular game of pass the parcel and it will take some time before the deal flow can start again. This is a definite case of acute financial indigestion.

Meanwhile, in the US corporate bond market, spreads on investment grade paper widened by 20 basis points over the month, while spreads on speculative grade issues widened by a very uncomfortable 100 basis points. The casualty list of hedge funds caught in the melt down is mounting and distressed sales are beginning to be forced into illiquid markets: further pain is to be expected. The ructions in the credit market have eliminated any nagging worries that the Fed may have to lift interest rates and hopes are rising that rates may actually be cut to assuage the pain. A widespread credit crunch is not in anybody's interests at this stage. However, such uncertain markets are just the sort of conditions that attract investors to the safe haven of government bonds.

The main economic news released over the month has given the government bond markets little cause for alarm. The US second quarter GDP came in a little stronger than expected at 3.4%, rebounding from the sluggish 0.6% first quarter number. The report details a welcome slow down in private consumption and an encouraging pick up in business investment. The core deflator at 1.4% is running at levels last seen in 2003 although the core CPI continues to run fractionally ahead of the key 2% level. In the UK, the Bank of England, as expected, lifted interest rates by a quarter point to 5.75%. A further increase to 6% is widely expected in the autumn. Meanwhile the European Central Bank has left markets on notice that interest rates will be going up at the conclusion of its next meeting in early September. European CPI remains steady at 1.9% but the economy continues to do well and monetary growth remains very strong with M3 growing at 10.9% over the last year. In Australia, the Reserve Bank remains on hold. Inflation there has fallen back down towards 2% faster than many had expected, but demand in the economy continues to grow

quickly, and capacity utilisation and employment levels remain at high levels. With this background Australian inflation is unlikely to remain subdued indefinitely and further rate rises are probable next year.

In summary, with the background of strong economic growth and rising interest rates in Europe and the Far East, bonds at current prices continue to offer very unexciting yields. However, we would not be surprised if the sovereign bond market continues to find support over the coming weeks. We have not seen the worst of the problems in the credit markets and the safe haven credentials of government debt should continue to attract buyers, if only over the short term.



EQUITIES

Markets are gyrating and volatility has rocketed. The VIX index of US equity volatility has risen to the mid 20s after spending much of the last few years in the low teens. The daily moves in markets have widened and 2% is no longer the exception. This see-saw action of recent days indicates that uncertainty prevails. It would be foolhardy to predict direction after a single day's move.

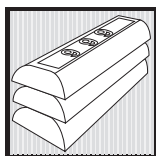
We believe that the main risk for equities is one of a sudden reduction in liquidity. This will not arise from a change in economic conditions; nor would any central bank contemplate any action which would cause sharp disruption. However, distress selling in a thin market could well cause disproportionate price movement and undermine collateral. Such asset price destruction would bring liquidity destruction in its wake. Another source of liquidity drain would be if banks find themselves unwilling or unable to grow lending because of unexpected events. In this context the drying up of parts of the secondary markets in credit have left banks holding loans for leveraged buy-outs which, although perfectly good paper, tie up their capital.

Unless this problem - and it is only a problem right now - becomes overblown we should not expect any significant disruption to global economic growth, which is being powered by an unstoppable China. Nor does output growth in China appear to be sufficiently overheated to elicit a monetary response from the Peoples' Bank of China.

So we are left with a jittery market which remains reasonably well supported by profit growth and valuation but is also sufficiently liquid to be an obvious source of funds if needs be. Profit expectations continue to be beaten by actuality. This is remarkable at such a late stage in the cycle and supports those who believe this to be an extended cycle. As we have noted before, valuations are acceptable if you believe this but less so if not. We should not, however, forget that this has been an extraordinarily profitable bull market and only the US and the UK have failed to double from the cyclical low points, while a number have tripled or more, admittedly after suffering disproportionate falls in the preceding bear phase.

Despite all the shenanigans and angst, unless you were yen based the World Index fell by only 2% to 3% during July, depending on your currency. For once, the yen rallied strongly. This raises fears about the implications of a reversal of the famous carry trade. We have already concluded that this is probably more reflective of Japanese domestic actions than high powered international investment money, but movements such as the 8% rise against the NZD, which has attracted huge foreign attention (much of it Japanese) because of its high interest rate, will have been a sobering experience for those who have lost a year's differential in a couple of weeks.

The first few days of August have seen some divergence in market performance with the US up by about 2% and Europe down by an equivalent amount. At the time of writing, markets are down 5% to 7% from their recent peaks but are still showing small gains from the beginning of the year. For all the noise and (limited) pockets of distress this does not yet even qualify as a correction. While markets are no longer over-bought, some have now dipped below their 200 day moving averages. We should remember that markets can also become oversold. It is quite unlikely that we have seen the end of this wobble.



GOLD/COMMODITIES

Oil has recently adopted the role of silent assassin with a barrel of WTI crude gaining 11% over the month to close at \$78.21, just a whisker away from its all time high. However, the potential repercussions for consumers and commerce were overshadowed, for the time being at least, by the turmoil in credit markets. The ascent was driven primarily by growing concern over fundamental imbalances with the International Energy Agency warning of a significant shortage within five years and fresh evidence emerging of OPEC's ability to defend higher prices. After two cuts in production targets since last October, the cartel is now producing one million barrels per day less than this time last year, despite rising demand.

The bears have switched their attention to the degree of speculative interest, which they claim is excessive. Whilst the market continues to be buoyed by the herd of punters betting that prices will keep rising, a reversal of the consensus view would likely lead to a sizeable and possibly rapid correction. The decisive factor in the near term will be the Atlantic hurricane season as we are fast approaching the time of year when financial forecasters impersonate their meteorological counterparts. For what it is worth, this is expected to be a more active season than normal, which would provide a further fillip to price. A relatively sedate period, on the other hand, could prompt the speculators to unwind their long positions.

Gold broke out of the trading range that had been hindering its progress since May and for the first half of the month, behaved as one would expect. With the US dollar

tumbling, it leapt to \$684/oz, the highest level in over two months. The stay was short lived, however, and come the equity market jitters it proceeded to erode most of those gains, closing the month just 2.3% higher at \$665.50. The precious metal is becoming worryingly vulnerable when equity prices come under pressure, although in this instance a concurrent bounce in the greenback was partly to blame. Whatever the cause, it is fair to start questioning its credibility as a diversifier. Having spent the best part of the year nestled between \$640/oz and \$690/oz and with there being little obvious catalyst for change it is hard to bet against more of the same for the foreseeable future.

Resources once again made headway, although there were one or two exceptions, with nickel continuing to plummet. The CRB Raw Industrials Index added a further 2.3% with two of its constituents, lead and tin, rising to fresh peaks. A fellow record-breaker was the Baltic Dry Index, which represents global costs of shipping major raw materials. Whilst it can be affected by potentially misleading factors such as congestion at ports, its near vertical climb since June last year implies demand for resources remains strong. Despite this seemingly favourable fundamental backdrop, several base metals look overbought and due a correction.

POLICY SUMMARY MATRIX

The matrix set out below is a summary of our current policy stance on the various equity and bond markets which we monitor. It is not intended as anything other than a guide on where we stand and we will change the content as our views alter. Cash exposure is a residual and will tend to be high when negatives outweigh positives and vice versa.

We remain overweight Japanese equities in growth portfolios but we are neutral elsewhere.

We have adjusted the matrix to reflect this.

6-12 Month View	Strongly Negative	Negative	Neutral	Positive	Strongly Positive
EQUITIES					
US		■			
UK		■			
EUROPEAN		■			
JAPANESE		□	■		
AUSTRALIAN		■			
ASIAN		■			
RESOURCES		■			
BONDS					
US		■			
UK		■			
EUROPEAN		■			
JAPANESE		■			
AUSTRALIAN		□	■		
OTHER			□	■	

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Gavin Roberts and Martin Paling

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No reader should take any action based upon the content of this publication without first seeking further and more detailed advice from Bentley Reid & Co or their own financial advisers.

MARKET PERFORMANCE

30th July 2007

All performance numbers show % changes except for bond yields which show yield changes.

	Now	1 mth	3 mth	12 mth
CURRENCIES (VS USD)				
GBP	2.0321	1.3	1.2	8.8
CHF	1.2034	1.8	0.3	2.3
AUD	0.8570	1.1	3.0	11.9
JPY	119.07	3.7	0.4	-3.9
EUR	1.3689	1.4	0.3	7.3
BOND YIELDS (10 yr)				
US	4.78	-0.26	0.15	-0.21
UK	5.25	-0.21	0.21	0.65
Germany	4.32	-0.24	0.17	0.40
Australia	6.04	-0.22	0.15	0.19
Japan	1.80	-0.07	0.17	-0.14
EQUITIES				
	Now			
UK. FTSE 100 (GBP)	6,360.10	-3.8	-1.4	7.3
US. Dow Jones (USD)	13,211.99	-1.5	1.1	18.1
Japan. Nikkei Dow (JPY)	17,248.89	-4.9	-0.9	11.6
Australia. All Ords (AUD)	6,187.50	-2.0	0.5	24.8
MSCI Pacific ex Japan (USD)	1,361.08	0.5	4.1	37.5
MSCI Europe ex UK (Local Currencies)	1,371.73	-3.4	-2.2	20.5
MSCI Latin America (Free) (USD)	3,804.60	1.3	14.6	56.3
MSCI World Index (USD)	1,565.81	-2.3	-0.8	18.0
MSCI World Index (GBP)	770.84	-3.4	-2.3	8.5
MSCI World Index (AUD)	1,838.67	-2.5	-3.3	6.2
COMMODITIES				
Oil (WTI)	US\$ 78.21	11.1	18.5	5.1
Gold	US\$665.50	2.3	-2.2	5.2

BC FUND PRICES**30th July 2007**

	Bid	1 mth	3 mth	12 mth
Friends Provident				
£ Balanced Mirror Fund	£ 1.198	-1.8	-1.5	+8.0
CF Bentley Capital Investment Funds				
£ Balanced	£ 1.3306	-1.3	-0.8	+9.0
US\$ Balanced	US\$ 1.1054	-1.4	+0.8	+11.9
£ Income	£ 0.9852	-1.5	-1.5	N/A
Royal Skandia				
A\$ Balanced	A\$ 1.512	-2.3	-0.9	+12.6
£ Balanced	£ 1.350	-1.7	-1.7	+7.7
US\$ Growth	US\$ 1.147	-1.5	-0.9	+13.7
EUR Balanced	€ 0.994	-1.8	-1.0	+9.2

All performance numbers show % changes.

If you would like us to email you the BC Fund Prices each month please email us a request to administrator@bentleyreid.co.uk

NEWS / VIEWS

BANK FRAUD - A TIMELY REMINDER

In this electronic age, clients and readers will be aware of the need to be vigilant to protect against identity theft, credit card, banking and other fraud.

This reality was evidenced recently by the circumstances surrounding one of our client's personal accounts at the Swiss bank we recommend. In this case, the client's husband received a telephone call from an individual pretending to be an officer of the Bank. The imposter asked for confirmation of the client's home address which was duly provided.

Shortly after this the Bank received a written instruction, titled with the correct client address and including the correct bank account number, asking the Bank to transfer funds to a (previously unheard of) account in Holland. The signature on the instruction was a forgery but a very convincing one. The Bank, to their credit, spotted that there was something unusual, referred to us and the client involved and the fraud was thwarted.

It seems clear that a communication, including the client name, signature and bank account had been intercepted. Clearly it involved telephone fraud as well.

Clients and readers will be well advised to inspect their personal mail for any signs of tampering and, if evident, to alert the post office and your bank (if the letter contained banking details).

Next, if you get a call from the Bank do not give out personal information. Ask for a return number and, if you have any grounds for suspicion, alert your Bank accordingly. For any clients, please let us know and we will help investigate where relevant.

Finally, for our Clients, when sending written withdrawal instructions or fund requests to either us or the Bank, where possible please give us a call to confirm the instruction. Indeed, please do not be surprised or offended if we ring to confirm the request if we have any grounds for suspicion. We would prefer to be safe rather than sorry.

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In conjunction with trusted third parties, we have extensive experience managing all aspects of private client residential and commercial property ownership. We can administer every aspect of physical property ownership including the initial search, purchase negotiations, renovations, sourcing a tenant and on-going rental management. In addition we can provide advice on both quoted and unquoted property investments and the most tax efficient way to hold any property interest.

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