



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

No. 9 of 2007

SEPTEMBER 2007

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- * Equities A very mixed bag after a mid month panic
- * Oil/Commodities Largely unaffected by turmoil elsewhere

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GENERAL COMMENT

GIVING CREDIT WHERE CREDIT IS DUE?

If this article had been written in the middle of August rather than in early September its tenor would probably have been very different. At that time equity markets were in something resembling freefall, government bond yields were plunging, and the credit markets appeared to have seized up. All this thanks to the extended and infectious repercussions from the travails of the US housing market and the crisis in subprime mortgages (yet another of those phrases which now roll off the tongue so easily but which almost nobody had heard of only a few short months ago). We covered many of the elements of the problems leading to this near-breakdown in financial markets in the last edition of Investment Views and we do not intend to repeat these here; suffice to say that when a situation develops in highly geared markets where large losses are being made (maybe \$200bn in the subprime mortgage area alone and considerably more potentially as the knock-on effects infect other areas) but where nobody knows either how large the potential losses are or where they may appear, then you have a recipe for a breakdown in the credit markets. This is a direct result of the fact that the original lenders no longer keep loans on their

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own books but instead package them up and sell them on to a multitude of other investors, all eager to enhance returns in a low interest rate environment, and of the related fact that original credit standards have become much more lax as a result. It matters much less to the lender whether the borrower is really creditworthy if he has sold the loan on to someone else. And it simply adds insult to injury if the financial magicians have turned junk into an apparent piece of AAA paper in the process....of course, they haven't really; they just appear to have.

As we were saying, by the middle of August all kinds of financial institutions from hedge funds to Chinese banks to off-balance-sheet structured investment vehicles controlled by very blue chip UK and European banks were owning up to having large exposures to investments which were worth a great deal less than they had been led to believe. Not surprisingly the financial markets took fright and the point was reached where even the most apparently robust institutions were not prepared to lend money to each other. One measure of the stress was the one month US Treasury Bill rate which touched a low of 2.56% at a time when the interbank rate was well over 5%. So worried were banks that they preferred to lend to the government at half the rate at which they were willing to lend to each other. Cynics suggested that this might have come about because if a bank knows that its own position is worse than it has owned up to then it is reasonable to assume that everyone else is in the same boat. The reality is simply that an effective credit market depends on confidence and the market had lost confidence. At this point the major central banks began to step in and by supplying large amounts of liquidity and in the case of the Federal Reserve reducing the discount rate (the rate at which they supply emergency money to the banking system and not to be confused with the more widely known Fed Funds rate which so far remains unchanged) they have restored a part of that lost confidence. In addition expected interest rate rises from the ECB and the Bank of Japan have been postponed if not abandoned. Equities, sold off because they retained some liquidity when cash had to be raised in a hurry, have recovered a sizeable proportion of their losses, short-dated bond yields have climbed way above the extreme low levels they reached and volatility has died down. So the picture now, in early September, is a big improvement on that of two weeks ago.

The underlying problems have not, however, gone away. What began in the subprime mortgage market has now extended to other areas of credit with many instances being reported of short term commercial paper proving very hard to roll over on sensible terms and with the possibility that other areas such as CDOs based on credit card receivables may cause problems as excessive consumer debt comes home to roost. In the UK, for example, the three month interbank rate remains at 6.5% compared with the 5.75% that is suggested by the current level of the base rate. It is very clear that there will be no going back to the lax credit standards seen only a short time ago. Credit will be more difficult to obtain and where there is any doubt about creditworthiness the price will be more expensive than before. The chances are that, particularly in the economies where borrowing has been very high such as the US, the UK, and Spain, there will be a knock-on effect on the real economy as the excesses are unwound. It is not impossible to envisage a sequence that goes along the following lines. Mortgage problems and the slowdown in the housing

market lead to a slowdown in consumer expenditure and greater difficulty in obtaining or renewing credit, this in turn slows the economy which leads to more consumer debt problems, rising unemployment and to an increased level of defaults by corporate borrowers.

Clearly if economic growth comes under threat and inflationary pressures, in consequence, disappear then Central Banks will be expected to react by lowering interest rates. That is as it should be, but they are in practice faced with a dilemma. Helping the economy is all well and good but by increasing liquidity and reducing interest rates as many in the financial community have been screaming for they would be perpetuating the problem of the Greenspan "put" which is arguably the root cause of many of today's difficulties. When Alan Greenspan led the Fed he responded to emerging financial crises by slashing interest rates and increasing liquidity thus ensuring that stability was restored, but in the process he bailed out many of the perpetrators of the excesses which had caused the crises and enabled them to go on to bigger and better excesses until the next crisis blew up. The whole cycle was then repeated with speculators and others confident that they could do what they liked because, if it went wrong, the Fed would bail them out. The mispricing of risk and high levels of leverage encouraged by this policy must be remedied. Fortunately the Fed does not look as if it is going to extend the life of the Greenspan "put" since the current Chairman, Ben Bernanke, is now on record as saying " It is not the responsibility of the Federal Reserve - nor would it be appropriate - to protect lenders and investors from the consequences of their financial decisions". This appears to mean that, whilst he stands ready to help the real economy if necessary, there will be no bail-outs. Similarly, in the UK the Bank of England has made it clear that it will provide liquidity to keep the markets moving but only at a price. If both these leading central banks follow the lead of Walter Bagehot whose advice in a crisis was "to lend freely but at penal rates" then we feel that some good may come out of the current upheavals. No one doubts that the advent of hedge funds and other similar vehicles has, on balance, been a healthy development especially in increasing market liquidity, but, equally, there is no doubt that a financial system built on properly priced credit and sensible levels of leverage will be better in the long run than one built on the kind of excesses that are now being found wanting. Hopefully the central bankers agree.

THEY SAID IT THIS MONTH

The action of the Federal Reserve is easing financial tensions by cutting the discount rate was very neatly summarised by a letter in the FT.

'Towards the end of the party, a fight broke out, so the Federal Reserve ordered another round of drinks to calm the participants'

There has been much recent comment (coinciding with exam results) on education standards in the UK, not least in connection with the proliferation of useless degree subjects. Readers might like to look at the following selection - five are real courses

and the other is made up by the editors but can you tell which one:

'Outdoor Adventure with Philosophy'
'Equestrian Psychology'
'Culinary Arts and Adventure Tourism'
'Bathroom Hygiene'
'Science: Fiction and Culture'
'Baking Technology Management'

Two reports this month highlight the hazards of motoring which can strike at both ends of the car market. Both are from the Daily Telegraph.

'Bentley, the car maker, has ordered 520 owners across the world to return their £200,000 Arnage and Azure models amid fears that wheels might fall off due to faulty bolts.'

'The car maker Vauxhall is recalling nearly a quarter of a million Corsas because of a fault that can cause them to spontaneously combust. The move comes after several Corsa owners reported the cars bursting into flames on their driveways'

And you thought traffic jams were the biggest problem!

Finally, a really stupid joke.

A couple go for a meal at a Chinese restaurant and order the "Chicken Surprise." The waiter brings the meal, served in a lidded cast iron pot.

Just as the wife is about to serve herself, the lid of the pot rises slightly and she briefly sees two beady little eyes looking around before the lid slams back down.

"Good grief, did you see that?" she asks her husband. He hasn't, so she asks him to look in the pot. He reaches for it and again the lid rises, and he sees two little eyes looking around before it slams down.

Rather perturbed, he calls the waiter over, explains what is happening, and demands an explanation.

"Please sir," says the waiter, "what you order?"

The husband replies, "Chicken Surprise."

"Ah! So sorry," says the waiter, "I bring you Peking Duck!"

For Nic's golfing corner this month we have an almost equally stupid story.

A golfer teed up his ball on the first tee, took a mighty swing and hit his ball into a clump of trees. He found his ball and saw an opening between two trees he

thought he could hit through. Taking out his 3-wood, he took another mighty swing; the ball hit a tree, bounced back, hit him in the forehead and killed him. As he approached the gates of Heaven, St. Peter saw him coming and asked, "Are you a good golfer", to which the man replied: "Got here in two, didn't I?"

MARKET COMMENT



CURRENCIES

It is not easy to detect a pattern in August's currency movements until one looks at what has been going on elsewhere in the financial arena. The turmoil in credit markets which spilled over into equities has been responsible for the two most pronounced changes this month and our old friend the "carry trade" was the proximate cause. The yen was the biggest gainer by a substantial margin with a gain against the dollar of 2.7%, whilst the Australian dollar led the fallers amongst the currencies we monitor and declined by 5%. Elsewhere movements were rather modest as the pound, euro and Swiss franc dipped by 0.7%, 0.4% and 0.4% respectively.

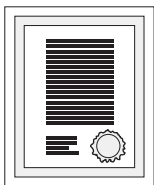
The movements in the yen and the Australian dollar relate directly to investors cutting risky positions which have been funded from yen where interest rates are very low. Australia with its 6.5% base rate has been an attractive home for money but changes in exchange rates, such as those mentioned above, swiftly eliminate any interest rate gains and lead to a rapid unwinding of positions. Interestingly the economic fundamentals might have suggested that the Australian dollar should have been going up and the yen down, rather than vice versa. Australia's economy is going very well, as the recently announced 4.3% year on year gain in GDP for the second quarter confirms, and the Reserve Bank raised rates earlier in August. In contrast, Japan remains roiled in deflation and is showing some signs of losing even the modest momentum seen over the last few months. It could be that the interest rate rises of last year were premature but indicators such as wage growth, retail sales, and business investment all suggest that growth is struggling. A huge creditor country such as Japan perhaps should deserve currency strength but deflation and a sluggish economy argue in the opposite direction.

As for the US, the revised second quarter growth rate of 4% was a strong number but it almost certainly borrowed something from the first quarter and there is little doubt that the next figure will be much lower, perhaps down to 1% or so. The dire state of the housing market and the mortgage problems have hit consumer confidence which fell sharply in August. If this is followed by weaker consumer expenditure, as current anecdotal evidence from retailers suggests it may be, then a significant slowdown will surely be on the cards. Hardly a recipe for a major dollar recovery.

In Europe the ECB has hinted that the rate rise signaled for September may be postponed in the light of the credit crisis. On current indications, though, despite

the efforts of President Sarkozy, we expect it to reappear on the agenda a little later on. In the UK the Bank of England will remain on hold for the moment against the background of a possible slowdown in the housing market and the likelihood of a reduced contribution to growth from the financial sector which has been such a driving force in recent years. If the pessimists are right and this latter factor is the precursor of a significant slowdown in growth then we could be at the peak for UK rates. As for China the 0.4% gain this month and the 3.4% appreciation this year to date against the dollar are rather modest suggesting that, whatever the US may feel, the authorities have not yet decided on an accelerated appreciation.

Given the fact that the global credit problems are certainly not over, although they may be past the critical point, it is likely that we will see a continuation of the recent pattern where these have been a more powerful influence on currencies than fundamental economics. If this proves not to be the case then it will be a sign that confidence in global markets is taking a turn for the better.



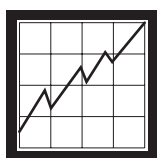
BONDS

The turmoil in financial markets created another lively month for the bond markets as prices for government bonds across the yield curve were bid higher. Ten year yields in the US fell by 0.25%, 0.21% in the UK, 0.19% in Japan, 0.07% in Germany and by 0.12% in Australia. Unusually, the sharpest moves in the US Treasury market occurred at the very shortest end, where yields collapsed as investors pulled massive amounts of capital out of risk assets and sought refuge in short dated Treasury bills. By mid-August yields on one month bills had fallen as low as 2.56% and this is in contrast with the Fed funds rate of 5.25%. This illustrates the severity of the strains currently afflicting the banking system and those trying to roll over short term loans have met severe funding difficulties. Although these problems originated in the subprime mortgage market, the issues have now spread across the credit markets and the crisis has started to impinge upon the functioning of the banking system. The US Federal Reserve and the other main global central banks have been on standby, and indeed have on occasions stepped in, to act as lenders of last resort to ensure that good credits can continue to secure funding. To further help ease the situation, the Fed reduced its primary credit discount rate by half a percent. However ultimately, the trouble in the credit market is not a matter of price, it is a matter of confidence.

The question remains for the bond market whether this crisis will feed through into the real economy. Losses in sub prime mortgages are likely to be huge, perhaps running in the order of \$100-200bn. While this is roughly the same amount that was lost in the savings and loans crisis in the early 1990s, the economy today is significantly larger in size and can better absorb such a hit. Losses of this magnitude equate to roughly 1.5% of US GDP, and they will be spread over an extended time period and dispersed across a wide range of international financial institutions. So the direct impact on the economy is likely to be muted, but assessing the impact of the loss of confidence in the banking sector and the follow through into the real

economy is impossible to gauge at this stage. On top of this, there is now little doubt that the housing boom in the US is well and truly over and this will begin to be reflected in consumption patterns. So to what extent does the Fed need to cut interest rates to accommodate this drop in demand? Market observers are suggesting that several cuts will be required over the coming months, with the first quarter point cut to arrive after the next Fed meeting on 18th September. A series of rate cuts may prove to be a too optimistic view however, given the inflationary pressures still in the system.

Central banks in Europe have been similarly busy supplying liquidity to the banking sector. The ECB has been particularly active after the near collapse of two German banks following difficulties with some off-balance-sheet funding conduits. The affected banks had to be hurriedly taken over by their larger brethren, though there are lingering concerns that these are not the only banks in trouble in Germany. In the UK, the Bank of England had to extend emergency funding twice to Barclays bank in as many weeks. Barclays was quick to claim that it was 'flush with liquidity' and the funding was required for technical reasons but this smacks of something worse than carelessness, especially as the bank is in the middle of a takeover battle for ABN Amro. This has done nothing to help confidence within the financial system and there are now doubts that the ECB will raise interest rates at its September meeting despite the coded message from its President at the beginning of August indicating that this was likely. Odds of a further rise in UK interest rates have also receded. Meanwhile in Australia the economy continues to motor along with the latest figures showing GDP growth at 4.3%, and the Reserve Bank of Australia had little hesitation at its August meeting in lifting interest rates by a quarter point to 6.5%.



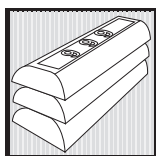
EQUITIES

The relatively modest changes in many equity markets for the month of August as a whole give little clue as to the degree of turbulence that actually occurred as they got caught up in the backwash of the global credit problems. By the middle of the month many markets had tumbled to 10% or more below their peak levels for the year, by the end in most cases they were back to where they had stood at the start of the month. The action of the Federal Reserve in reducing its discount rate, and, along with several other central banks, in providing emergency liquidity, restored a degree of confidence and inspired the bounce.

Over the month as whole the S&P 500 in New York actually rose slightly, the UK FTSE100 fell by less than 1%, and Tokyo slipped by 5.7% for the Topix but this was partly caused by, and indeed for foreign investors was partly offset by an extremely strong yen. The World Index fell by 0.3% in dollars but rose by 0.5% in pounds. Outside the big markets there were some notable features with many emerging markets, which had held up very well in July when the cracks in the major indices were beginning to show, falling by sizeable amounts including Malaysia

down by over 7% and Thailand by more than 5%. However the really spectacular performance came from the Chinese markets, including Hong Kong where a further liberalisation of Chinese domestic outflows provided a major boost. Shanghai A shares soared by 17% whilst the H shares in Hong Kong jumped by 7%. Clearly no one told Chinese domestic investors that there were some credit problems in the big wide world outside. Some bubbles may be bursting but not yet this one.

Although there is no immediate linkage between equities and the subprime mortgage related difficulties stock markets are generally very liquid and thus met selling from funds desperate to raise cash but who were unable to sell some of their more obscure assets. Hence the sharp setback in the first half of the month. Looking further ahead there will be two particular aspects relating to valuation that will need watching. Firstly the falls in bond yields, if those we have already seen are not reversed, and any subsequent decline in short term interest rates will enhance the relative attraction of equities. But working in the opposite direction may be a decline in economic activity and a consequent reduction in earnings forecasts which would undermine a valuation basis currently relying on continuing earnings growth albeit at a slower rate than seen in recent months. Investors have a tendency to underestimate the time lags involved in changes in economic activity following policy changes or extraneous shocks such as we are seeing now and it will be some time before the outcome is clear. But, on the assumptions that the real global economy is not too seriously damaged by recent events and that we are not about to embark on a significant downturn in activity, there does not seem to be any reason to be overly bearish at present. Clearly there are risks that, particularly in the financial sector, there may be more shocks to come, but overall we feel that our cautious but not overcautious stance is probably about right until the dust has settled a little more.



GOLD/COMMODITIES

Commodity investors could be excused for feeling a little queasy after a month in which they witnessed wild swings in prices across more or less the entire asset class.

The oil price proved no exception and suffered a sharp fall at the start of the month as speculators unwound their positions, leaving the number of net long outstanding contracts at a six month low. Whilst this can be attributed to concerns that the credit squeeze would hamper worldwide economic growth, the forced selling by hedge funds and their ilk to finance liabilities elsewhere also proved influential. A barrel of WTI oil closed the month at \$74.04, a decline of 5.3%. The fall would have been more pronounced had it not been for a decent rebound in the closing stages, which was triggered by fears that Hurricane Dean would disrupt production in the Gulf of Mexico. Despite testing conditions, the price remains near historic highs and whilst the energy market is far from immune to any significant slowdown in global activity, OPEC's recent statement that oil supply is ample supports the argument that price will stay at an elevated level.

Anyone prescient enough to foresee the travails across the financial system last month would have been disappointed by gold's reluctance to provide meaningful protection. The marginal rise of 1.2% during August to \$673/oz masks the contraction in price when equity markets were under intense pressure. For some time, we have opined that the proliferation of exchange traded funds and the type of short term speculator that they attract has led to the performance of gold becoming more intertwined with other assets and this latest episode does little to dampen our view.

Base metal markets were spooked by claims that weakness in financial markets could be a harbinger of significant economic slowdown and with it a tempering of the voracious demand for resources that has featured so prominently in recent years. That said the CRB Raw Industrials index fell by only 2.3% in August, which reflects both a strong intra-month recovery from the likes of copper, lead and zinc and a continued surge in soft commodity prices, particularly wheat, which leapt to a record high above \$8 a bushel on the Chicago Mercantile Exchange. Agricultural products aside, providing the favourable economic backdrop remains intact, recent falls in resource prices can be viewed as a healthy correction. It is too early, however, to ascertain if this is indeed the case and it will likely take some time to judge with any degree of conviction whether or not the so-called commodities super cycle has been derailed.

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.

Following recent equity falls we have cut back the cash position in growth accounts by reducing the underweight in the US and by bringing the UK exposure back to neutral.

This is reflected in the matrix this month.

| 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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MARKET PERFORMANCE

31st August 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 | 2.0171 | -0.7 | +2.0 | +6.0 |
| CHF | 1.2083 | -0.4 | +1.4 | +2.0 |
| AUD | 0.8140 | -5.0 | -1.7 | +6.5 |
| JPY | 115.92 | +2.7 | +5.1 | +1.2 |
| EUR | 1.3633 | -0.4 | +1.3 | +6.5 |
| BOND YIELDS (10 yr) | | | | |
| US | 4.53 | -0.3 | -0.4 | -0.2 |
| UK | 5.04 | -0.2 | -0.2 | +0.5 |
| Germany | 4.25 | -0.1 | -0.2 | +0.5 |
| Australia | 5.92 | -0.1 | -0.1 | +0.2 |
| Japan | 1.61 | -0.2 | -0.2 | -0.0 |
| EQUITIES | | | | |
| | Now | | | |
| UK. FTSE 100 (GBP) | 6,303.00 | -0.9 | -4.8 | +6.7 |
| US. Dow Jones (USD) | 13,357.74 | +1.1 | -2.3 | +17.4 |
| Japan. Nikkei Dow (JPY) | 16,569.09 | -3.9 | -7.3 | +2.7 |
| Australia. All Ords (AUD) | 6,248.30 | +1.0 | -1.5 | +23.0 |
| MSCI Pacific ex Japan (USD) | 1,329.55 | -2.3 | +0.1 | +31.0 |
| MSCI Europe ex UK (Local Currencies) | 1,360.54 | -0.8 | -5.4 | +15.7 |
| MSCI Latin America (Free) (USD) | 3,683.02 | -3.2 | +0.7 | +50.0 |
| MSCI World Index (USD) | 1,561.59 | -0.3 | -3.4 | +14.9 |
| MSCI World Index (GBP) | 774.17 | +0.4 | -5.2 | +8.5 |
| MSCI World Index (AUD) | 1,918.41 | +4.3 | -1.8 | +7.8 |
| COMMODITIES | | | | |
| Oil (WTI) | US\$ 74.04 | +5.3 | +17.9 | +5.4 |
| Gold | US\$673.40 | +1.2 | +1.7 | +7.9 |

BC FUND PRICES**31st August 2007**

| | Bid | 1 mth | 3 mth | 12 mth |
|--|-------------|-------|-------|--------|
| Friends Provident | | | | |
| £ Balanced Mirror Fund | £ 1.172 | -2.2 | -4.6 | +4.7 |
| CF Bentley Capital Investment Funds | | | | |
| £ Balanced | £ 1.3134 | -1.3 | -3.7 | +6.7 |
| US\$ Balanced | US\$ 1.0941 | -1.0 | -3.0 | +9.3 |
| £ Income* | £ 0.9882 | +0.3 | -1.4 | N/A |
| *3 mth performance incorporates dividend of 1.86p per unit | | | | |
| Royal Skandia | | | | |
| A\$ Balanced | A\$ 1.558 | +3.0 | +0.3 | +13.0 |
| £ Balanced | £ 1.321 | -2.1 | -4.8 | +4.3 |
| US\$ Growth | US\$ 1.122 | -2.2 | -4.7 | +9.1 |
| EUR Balanced | € 0.978 | -1.6 | -3.8 | +5.6 |

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

THE PENSIONS ACT 2007

The Pensions Act 2007 became law on 26th July 2007. One very important provision is that the requirement to be eligible for the maximum basic state pension will become 30 years NI contributions or credits rather than the current rather higher (and more complicated) requirement. However, this will only apply to people reaching state pension age on or after 6th April 2010.

This is likely to be important for those people who are currently making voluntary NI contributions to maintain their state pension eligibility.

For further information, follow the link below

<http://www.thepensionservice.gov.uk/pensions-reform/home.asp>

Ralph Davis
Bentley Reid and Co (Europe) Ltd

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