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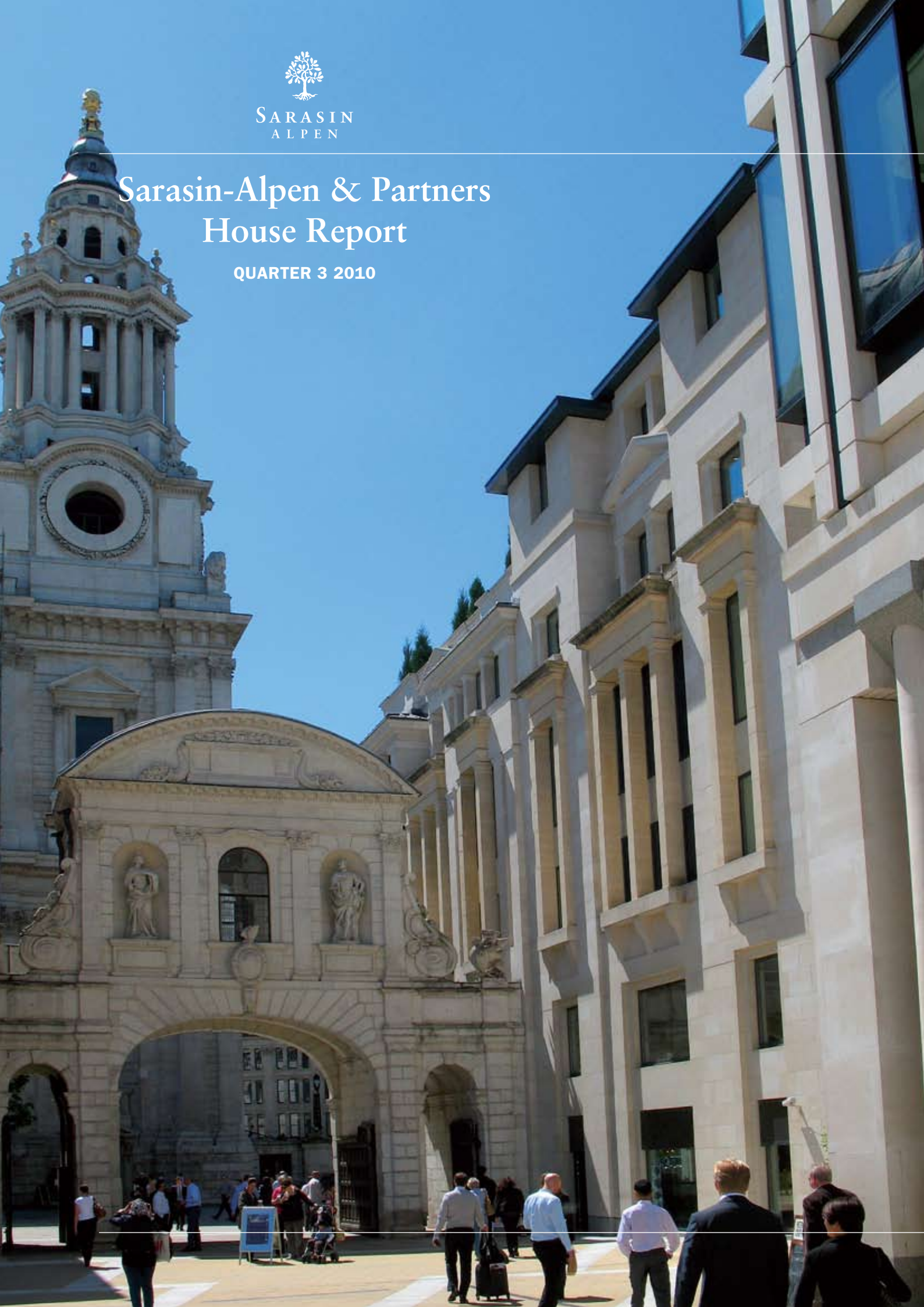




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Sarasin-Alpen & Partners House Report

QUARTER 3 2010



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SARASIN-ALPEN & PARTNERS HOUSE REPORT is a quarterly publication providing informed analysis and advice on topics of interest for the private client and institutional investor.

Introduction



Paul Cooper
Managing Director, Sarasin-Alpen & Partners Ltd.

It is with great pleasure that I enclose the eighth edition of the Sarasin-Alpen & Partners Quarterly House Report. The main body of the report is once again written by Guy Monson, Chief Investment Officer of Sarasin & Partners, the UK subsidiary of Bank Sarasin. Guy's ability to explain some of the most complex financial issues has made his "Market View" essential reading for clients and friends of the Sarasin Group. I am also pleased to include a report on the global real estate sector, written by Jakes Ferguson, head of real estate investments at Sarasin & Partners.

Before we get to Guy, a few words from me on the risks & opportunities of investing in this region.

The 2nd quarter was a challenging period for investors. Turmoil in Europe and concerns that efforts to control the rate of growth in China might induce a more severe economic slowdown, raising fears of a global "double-dip", caused a de-risking of portfolios across the world. Almost all risky assets fell in value, with equities, commodities and real estate coming under heavy selling pressure. Even in the United States, which was experiencing a solid, if unspectacular, economic recovery, the equity market fell by 12% - its worst performance in a single quarter since Q4 2008.

Equity markets in the Gulf also reacted badly to these global tensions, even though, apart from the oil price, there was little that directly impacted the region. On the contrary, the global problems should have highlighted the strengths of the Gulf. Specifically, while

Europe (and the US) struggle to cope with high levels of government debt and record budget deficits, the GCC with its budget surpluses and almost zero debt stands out as a beacon of financial prudence. Similarly, while investors worry that inflation pressures in China and India will force interest rates higher and slow their economies in 2011, the Gulf is unlikely to raise rates because of its currency peg to the US Dollar.

Naturally, there are risks but the International Monetary Fund's upgrade to global economic growth as recently as July 7 (from 4.2% to 4.6%) should provide comfort that the underlying backdrop is robust. While 4.6% growth (falling to 4.3% in 2011) does not match the record 5.0% reached in 2006 and 2007 it compares extremely favourably to growth rates achieved over the longer-term. One must be careful, therefore, not to exaggerate the risks and, as a consequence, miss the opportunities.

And there are plenty of attractive opportunities in the Gulf. The following table consists of data produced by the internationally renowned research organisation, Business Monitor International (BMI). BMI studied 145 countries around the world and ranked each of them on the basis of their economic

strength; specifically “the degree to which each country approximates the ideal of non-inflationary growth with falling unemployment, contained fiscal and external deficits and manageable debt ratios.” The results for the GCC and a selection of other countries are shown below:

BMI Rating: Short Term Economic Strength

GCC	Rank *	Developed World	Rank *
Qatar	5	Switzerland	15
Oman	5	Germany	32
Kuwait	12	Japan	44
Saudi Arabia	16	UK	52
Bahrain	16	France	62
UAE	26	US	67
Average GCC	13	Average	45

BRIC	Rank *	Peripheral Europe	Rank *
China	1	Italy	55
Brazil	35	Spain	81
India	38	Portugal	84
Russia	60	Greece	116
Average	34	Average	84

**rank out of 145 countries analysed*

Source: Business Monitor International, July 11, 2010

Although many readers will find the above results surprising we can nevertheless say with confidence that the GCC is extremely well placed to weather the current financial turmoil. Its future also looks bright as massive government investment to secure economic diversification combined with low interest rates should ensure strong economic growth in the coming years. At a time when markets are battered by uncertainty and volatility, we take great comfort from the fundamental strength of the region.

Of course, Dubai continues to offer the potential to disappoint but as it represents just 8% of the GCC economy the impact of any setback should be modest. The financial

strength of Abu Dhabi is such that the UAE is ranked 26 out of 145 countries for short term economic strength. When Dubai's issues are resolved the ranking of the UAE is sure to rise.

Unfortunately, investors sold indiscriminately last quarter, with little respect for fundamentals or valuations. Volumes fell to record low levels as international investors, who were active in Q1, remained on the sidelines. However, this weakness leaves the market attractively valued, providing us with an opportunity to buy into the excellent long-term story at near-record low levels. I doubt we will get another opportunity.

At long last...



Visit www.sarasin.co.uk to access a special webcast, presented by our Chief Investment Officer Guy Monson, released for this House Report.

Guy Monson
Chief Investment Officer, Managing Partner
Sarasin & Partners LLP, UK

“In view of the recent economic situation and financial market developments at home and abroad, and the balance of payments (BOP) situation in China, the People’s Bank of China has decided to proceed further with reform of the RMB exchange rate regime and to enhance the RMB exchange rate flexibility.” Peoples Bank of China Saturday 19th June, 7pm.

With these simple words, camouflaged perhaps beneath the European currency crisis, the Chinese authorities have fired the starter gun for transition to a more flexible, market-driven currency regime across much of the emerging world (see chart 1 overleaf). Yes, the market euphoria has been short-lived, and certainly the Chinese authorities have done everything to dampen expectations of an immediate appreciation (just as the Americans politicians have done everything to call for the reverse), but the die is cast and the next stage of our global rebalancing thesis has begun.

Short-term implications are difficult to read. Other Asian currencies should continue to rise, capital should flow into Chinese assets in anticipation of multi-year currency gains, and domestic bank and property stocks across the region should perform. But of course, so much ‘smart’ money has tried to anticipate this move that the journey might turn out to be better than the arriving, as we have seen in the global market declines this month. However, the longer term

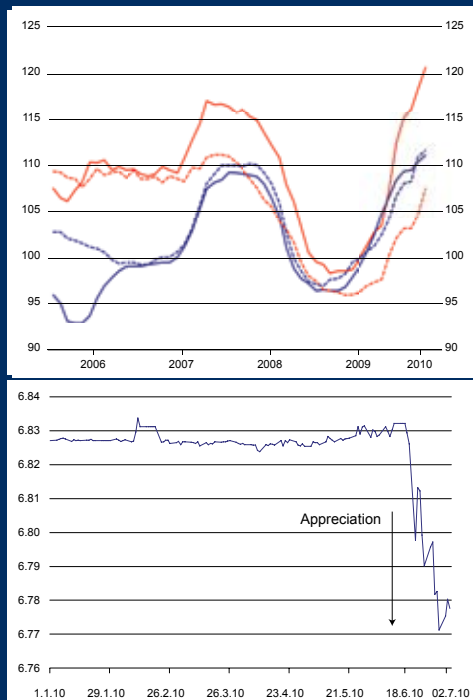
implications are clear - a stronger currency and a rebalancing of the Chinese economy toward domestic demand is the logical next stage for an economy seeing rising import prices and soaring wage costs. Over time the advantages are clear; it will tend to be reflationary for the global economy and deflationary for China (which should benefit both), it will reduce trade friction and rebalance global demand. For investors, this should ultimately support a renewed rally in risk assets, increase the risks in bonds at today’s super low yields, and reinforce our much repeated ‘Nifty Fifty’ global equity story. This is especially so for the giant exporters based in France and Germany, whose combined exports exceed either those of China or the USA by almost 25%...

A faltering recovery in the US still meets blistering growth across the emerging world...

Against this backdrop, the economic news has been anything but dull - the global economic recovery is still accelerating

Chart 1: The pressure finally showed...

China Real Estate prices have risen rapidly in prime locations



(as the IMF highlighted last week), but the ability for the US and Asia to effectively 'trade through' the debt crisis in Europe is becoming more difficult. Industrial production still remains the engine of the recovery, rising over the year by 7.6% in the US, 9.5% in the euro zone (the fastest since 1991), and by a staggering 25.9% in Japan. Similarly impressive numbers are being seen in the emerging world; while we have almost come to expect Chinese GDP to grow at today's blistering 11.9%, it is extraordinary to see India and Brazil also producing 'China-like' expansions of 8.4% and 9% respectively in the first quarter. This is not, of course, trouble-free - the Brazilian Central Bank has already increased interest rates, while India, despite its more acute inflation problem (consumer price inflation was close to 14% in May) has been slower to react and now has a problem of increasingly embedded inflation expectations. In China, the excessive liquidity is showing up in an overheated property

"China's policy of keeping its currency undervalued has become a significant drag on global economic recovery. Something must be done."

PAUL KRUGMAN
New York Times, March 15, 2010

At least five Senators and 130 House members of US Congress are calling for the Administration to call the yuan a 'manipulated' currency.

"The opinion of the IMF is that the Renminbi" is very much undervalued"

Dominique StraussKhan
at the European Parliament March 17, 2010

*The Renminbi is the official name of the Chinese currency.

The heads of the Indian and Brazilian Central Banks expressed their concerns about yuan undervaluation ahead of the G-20 meetings.
Source: FT, 22 April 2010

market, which authorities have targeted with multiple tightening measures.

We are hoping to profit from this and associated appreciation across other Asian currencies by increasing holdings for our balanced and charity clients in short-dated emerging market bonds and currencies. In our thematic accounts we are buying providers of factory automation equipment to help keep production costs down in China following recent labour strikes, as well as infrastructure and high speed rail providers to move labour and goods inland.

German industrial production surges in the face of euro weakness.

In Europe, by contrast, the increasingly evident design flaws in the euro are producing wrenching economic adjustments. However, we believe that the market may be underestimating the sustainability of the euro. Not only do the recent government support packages amount to approximately 75% of government debt in Spain, Portugal and Greece, but for the critical Spanish economy (11% of euro zone GDP) even a bank bailout as bad as Thailand in 1997

would result in total government debt at about 85% (from 66% in 2007) of GDP - still a manageable level. The European Central Bank (ECB) has already completed two U-turns (allowing Greek debt to be swapped with the Central Bank, and directly buying the debt of peripheral European economies), so a 'third' (open-ended quantitative easing, or 'QE') is also possible, and even likely. Since the start of the credit crisis, these measures have already swelled the ECB balance sheet by two thirds, leaving the euro broadly intact and sustainable but also significantly weaker - itself a critical part of the euro survival plan. European exporters are the ultimate winners.

Meanwhile, in the UK, a furious economic debate rages over the new Chancellor's radical budget and the anti-Keynesian bias of UK fiscal policy...

On 22 June, a well telegraphed but still extraordinarily tight fiscal budget was delivered by the youngest UK Chancellor since 1886; budget cuts of 25% over four years for all government departments outside of health and overseas aid were accompanied by a series of measures to boost international competitiveness (including a multi-year reduction in corporation tax). Along with an earlier announcement of the creation of an 'Office for Budgetary Responsibility' the combined policy sets a very bond market friendly, fiscally conservative trajectory for UK finances, standing in sharp contrast to the overtly Keynesian 'maintain public spending for fear of something worse' policy of the previous administration. So far the markets are applauding with sharply lower UK bond yields and a rising pound; Fitch (the global rating agency) has announced that this "ambitious" plan ensured Britain would keep its AAA credit rating.

For our investors, we have started to normalise our exposure to sterling (reducing our strongly underweight position of the last 18 months), while using the extraordinary rally in gilts last month to reduce holdings further, seeing little value in today's super low yields except potentially in index-linked issues. Otherwise, our determinedly global exposure, both in equity selection and geographic bias, means that we hope to largely avoid the risks of either side of the fiscal argument which holds so many dangers for domestic UK accounts.

Policy Implications

Against a backdrop of volatile economic data, fundamental moves in the tectonic plates of currency markets, and rising inflation across most of the emerging world, the investment markets, initially at least, appear confused. How should investors react?

1 Amidst this confusion, it seems to us that the 'blue-chip' global company is the equity of choice. First, because rises in inflation and input costs can normally be transmitted to customers, offering a certain economic independence from the inflation/deflation debate currently raging. Second, unit labour costs are falling in the West at almost their fastest rate for 50 years, while non-financial cashflow is climbing at its strongest rate in several decades, giving companies tremendous financial autonomy and consistent dividend increases well in excess of inflation. Finally, strong global growth across the emerging world, and demand for more sophisticated additions to infrastructure spending (including power stations, robotics, high speed transport and sophisticated healthcare equipment) is offering opportunities to leverage intellectual property and new technologies held in Western technology, infrastructure and pharmaceutical companies.

- Indeed, we have been impressed by the determination of management to maintain margins, even in the face of rising input costs. We are therefore retaining our focus on our much discussed global 'Nifty Fifty' of export-driven, cash rich, global businesses at the heart of our EquiSar family of funds.
- 2 The Chinese currency move, modest though it is in the short term, is still likely to attract funds to Asia in anticipation of currency increases. However, we still prefer to play this funds-flow story via short-term EM bonds, rather than sanction an increase in our global emerging market equity holdings. There are, of course, regional and thematic exceptions here, but we simply find the valuation and currency advantages of Western names compelling.
 - 3 We continue to find global equity dividend income markedly more attractive for long-term income generation than the ultra-low nominal yields produced by bond markets, both corporate and government. Yes, over the last six weeks the extraordinary fall in yields has proved a welcome offset to higher equity market volatility, but at today's levels bonds simply cannot satisfy our total return targets or the inflation risk budgets we have across our client base. Dividend increases continue to be pleasingly above expectations across our global universe.
 - 4 We continue to see the most abnormally high correlations across global markets as investors appear to see asset allocation today as a simple 'risk-on or risk-off' decision. Equity/bond yield correlations are at multi-year highs, equity/commodity correlations are near to all time highs, while the dispersion of individual stock returns continues to narrow. Such behaviour could simply imply fear of another 2008 debt crisis, or a Chinese hard landing which impacts all real assets simultaneously. But it also reminds us of equity markets in 2002, when - in the second year of the technology crash - correlations surged in a final rush by investors to 'de-risk.' The resulting sell-off left huge value opportunities, which produced five years of extraordinary alpha opportunities across world markets. Our thematic opportunity sets are highlighting similar pools of value today.
 - 5 We are of course reviewing our substantial gold holdings for clients as new records are reached in all major currencies. While we are aware that speculative holdings and record volumes held within ETFs (Exchange Traded Funds) now far outweigh weakening jewellery demand, we do still see the metal as a very effective hedge against the possible failure of the more radical fiscal and monetary policy being adopted globally. We also continue to be concerned by the risks in the US fiscal outlook and the reluctance of the Obama administration to consider even a mid-dated fiscal consolidation plan. We believe that gold will remain an effective hedge against a dollar currency crisis.

Fund Focus: Property 'Real Value'



Jakes Ferguson
Head of Real Estate Investments
Sarasin & Partners LLP, UK

We are surrounded by it, and it affects and touches our lives at every turn: real estate is the third leg of the stool, without which the economy would topple.

Property – we can't live without it

Property provides shelter, a sense of belonging to a community, and security (as per Maslow's hierarchy of needs). It is most people's largest asset (and therefore a store of wealth) and, for some, it is the ultimate status symbol. For companies, their brand or image is reflected in their building or offices.

For a logistics company or retailer, the drive for efficient and maximum distribution renders land in close proximity to road, rail, port and airport connections more valuable. The demand for logistics space may be export driven; with weak sterling, we might expect to see a pick-up in demand for warehousing at airports and near ports.

If the land in question is situated in a favourable time zone for international business, with a labour force with the right languages or skills, or with favourable flight times and connections to neighbouring markets, it is more valuable still.

Government policy and taxation can make land more valuable. The footloose international company that may place its HQ anywhere in the EU will be influenced

by taxation on 'non-doms', and on overseas earnings, and grants to encourage FDI (foreign direct investment) to certain regions.

Land for housing is worth more if it is closer to such places of work, to shopping and cultural facilities, schools, parks and leisure facilities. The supply and price of developable land will depend on planning laws, and access to services like electricity and water.

Rent and other influences

The key is the ability of land to earn rent. For a shop to pay rent it must sell its goods to shoppers, and so the links between rent, healthy employment and GDP growth, and thereby the value of land, are very direct.

When carrying out an appraisal, a developer works backwards from the finished capital value of his property. From this end-value he deducts his costs of production, construction, fees and finance to deduce what he can afford to pay for the land if he seeks a given profit or return on his capital.

Interest rates and the availability of capital or debt from finance sources are vital. The developer will usually use little of his own

capital, and seek loan finance to buy land and pay for construction. In periods like 2007-2009, the availability of credit for construction and development dried up as banks closed their loans books, rents fell, end-capital values shrank and development became unviable. The cost of holding an empty property became prohibitive, with many ending up on the books of the banks that lent to finance them: the credit crisis had come full circle.

For businesses looking to grow, the cost of renting land or property will be influenced by the total cost of occupancy, including the level of local taxes or rates, and service charges (whether the building is new or old, air-conditioned or not), as well as the cost and availability of employing staff. A lack of staff may force occupiers out of locations to look elsewhere, another town, or even another country.

Timing and cycles

Because of the development cycle (it can take many years to obtain planning permission for a sizeable development, and 2-3 years to construct an office building) there is always a lag between the signs in the economy justifying a start on site, and the completed article. As developers can often stop a development quite quickly upon signs of trouble ahead, there may also be a number of schemes that have been part-completed. Consequently, when the signs of the economy picking-up are evident, a number of schemes will often start at once.

When the cycle is well developed and rents are rising strongly, before long there is a supply of new buildings, and developers who

are fighting for tenants must begin lowering rents and offering more generous incentives. Sometimes it is hard to establish exactly how much rent is being paid, and over what term of lease. Thus, real estate markets go from famine to glut.

Current appeal of the UK to overseas investors

Currently c.80% of all investment deals in the UK are bought by overseas investors. The weakness of sterling, the nature of UK institutional leases (generally 15 years+), and our FRI (full repairs and insurances, all paid for by the tenant) leases, make the UK a desirable place to buy property. Combine this with the liquidity, relative political stability, transparency, regulation and valuation practices; the UK is currently a honeypot for Sovereign Wealth funds.

Going global with Real Estate Investments Trusts (REITs)

We invest in top-class REITs which own the best property in the regions we wish to invest in, and in sectors which we believe will outperform. These REITs have expert teams to manage properties, and to undertake development, finance and marketing.

Given the ties between real estate and the economy, interest rate and currency policies, GDP growth and politics, and their alignment with our personal, corporate and national wealth; we consider real estate inextricably linked to improving world economies, and as an inflation hedge.



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