

Financial Reality Index

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Research
Centre

 Analysis

Alliance Trust Research Centre has developed an index which measures financial conditions facing UK consumers. The Financial Reality Index has been calculated over the 10 year period from 1997 to 2006 and the key findings are:

- The Financial Reality Index reached a high of 132.0 in Q4 1999 but had fallen to a record low of 73.2 by Q4 2006, reflecting extreme pressure on household budgets plus record high levels of consumer debt.
- The Economic Background Index stood at 118.5 at the end of 2006, indicating relative strength in both economic growth and the labour market.
- The Household Budget Index reached an all time low of 32.1 in Q4, reflecting the struggle to cope with declining real incomes, high council tax payments, increased costs of basic goods and rising interest rates.
- The Net Wealth index fell below the critical level of 100 during 2006 and ended the year at 96.3. Property prices and equity markets performed well, but the debt burden continued to grow.
- Recent divergence between the Financial Reality Index and consumer spending growth suggests that spending will weaken over the coming months as consumers take a 'reality check'.

Our Conclusion – Consumer Spending Expected to Weaken

Our Financial Reality Index was constructed as a tool to measure the long and short-term financial health of consumers. It employs a wide variety of measurable variables, chosen to reflect important economic background factors, budgetary considerations and wealth accumulation and preservation. The index has been calculated on a quarterly basis over the ten year period since the beginning of 1997. During much of that time, it has shown a close correlation with the trend in consumer spending.

Throughout the whole of 2006 the Financial Reality Index remained below the critical level of 100 and weakened steadily towards a record low at the end of the year. In particular, this reflected the pressure on household budgets stemming from high levels of council tax, increased costs for basic goods and services, rising interest rates and increased levels of debt. But household expenditure growth increased, reaching 2.5% in Q4. This divergence between the Financial Reality Index and household expenditure suggests that consumers are becoming increasingly stretched in trying to maintain their existing lifestyles. Debt is becoming a bigger burden, particularly

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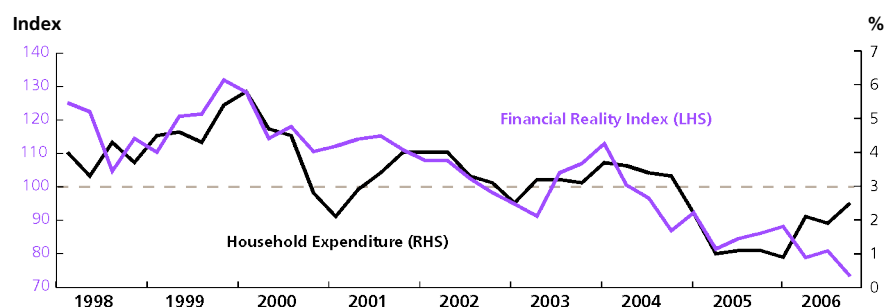
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Alliance Trust PLC is the largest generalist investment trust company listed on the London Stock Exchange. The Research Centre is part of Alliance Trust and was formed to carry out economic and social analysis to deepen our understanding of economies, markets and socio-economic issues.

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Financial Reality Index v Household Expenditure



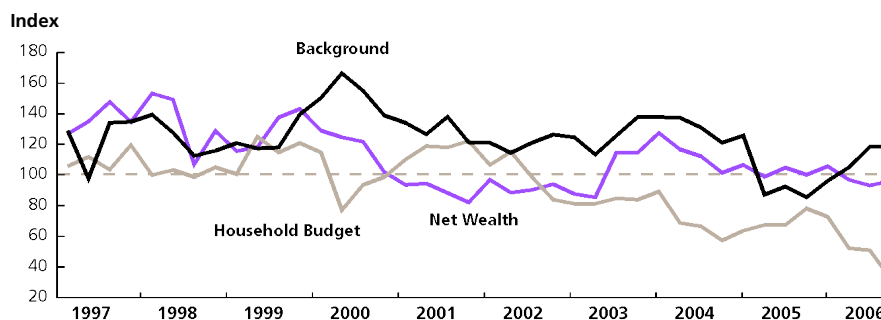
as interest rates, and the cost of servicing debt, are increasing. We expect future household expenditure growth to soften as consumers take a 'reality check' regarding their financial situation.

Explaining our results

Our key findings show that:

- The Financial Reality Index peaked at a level of 132.0 in Q4 1999 reflecting a favourable economic background, relatively mild pressures on household budgets and strong stock market performance. The index slipped during the global economic slowdown and equity bear market in the following years, but recovered to a level above 100 in 2003, supported by improving economic conditions. During 2006, the Financial Reality Index deteriorated, due primarily to significant household budget pressures as income gains failed to keep up with rising costs, taxes and interest rates.
- The Economic Background Index peaked early in 2000 reflecting high levels of GDP and employment. This index then declined during the next two years but remained above the critical level of 100, reflecting the fact that the slowdown in the UK economy was not as severe as that experienced in many other countries. Lower GDP growth and rising concerns about debt and insolvencies caused the background index to dip into negative territory in 2005, but it has since recovered in line with higher GDP growth and strength in the labour market.
- The Household Budget Index reflects trends regarding both income and expenditure. This index has been in negative territory consistently since the second half of 2002, and fell to a record low at the end of 2006. Severe strain on household budgets has come from high levels of council tax, rising interest rates and significant increases in costs for necessities such as food, petrol and heating
- The Net Wealth Index peaked at 153.1 early in 1998, due to strong stock market performance and rising property prices. However, the global economic slowdown and bear market in equities took their toll and the index slipped to a record low of 82.2 in the final quarter of 2001. Although

Financial Reality Index - 3 Components



equities and property both performed well in 2006, rising debt levels detracted from net wealth and the index dipped into negative territory in the second quarter of the year, falling to 96.3 in Q4.

Methodology

Alliance Trust Research Centre has developed an index measuring consumer financial wellbeing in the UK. This index is constructed using only measurable variables as the purpose is to measure the 'reality', rather than the 'perception', of household finances.

Our model is constructed on the belief that the underlying strength of a consumer's financial situation is influenced by many factors. This model incorporates 11 key variables which are measured in terms of either actual levels or rates of change. In each case, the long-term average of the variable is measured and set equal to 100, which is deemed to be the mid-point of the index. Individual readings for each variable are then scaled on a range from 0-200, depending on deviation from the mean. Values below 100 reflect negative influences whilst values above 100 reflect positive influences. The Financial Reality Index is calculated as an average of all 11 components, with each variable given equal weight. This method of construction allows us to capture and quantify the influence of prevailing economic conditions, recent income, tax, interest rate and cost developments, plus changes in households' longer-term store of net wealth.

The Financial Reality Index has a 10-year history starting in the first quarter of 1997. All of the data used in the model is official and is sourced from the ONS, the DCLG and the CML. In several cases, in-house analysis has been applied to basic

data to construct the selected series.

The model has been designed to produce three important sub-indices, created by combining the 11 identified variables into distinct groups focusing on the Economic Background, Household Budgets and Net Wealth. These three indices are calculated in a similar manner to the headline Financial Reality Index, and again have a mid-point of 100, a maximum of 200 and a minimum value of zero.

Economic Background - we have used three variables to reflect background economic factors in our model i.e. current GDP growth, strength of the labour market and the incidence of personal insolvency.

Household Budget - our index is designed to measure the prevailing financial situation facing consumers, and therefore uses several variables to reflect regular household income and expenditure. We use real, as opposed to nominal, measures of both earnings and disposable income, and capture important out-goings such as council tax, mortgage payments and the costs of basic goods and services.

Net Wealth - we believe wealth to be an important variable in providing a longer-term perspective on the consumer's financial situation. This is measured in terms of both property and equities using asset values and rates of change. We also include consumer debt which has displayed significant growth over the last few years, making it one of the key elements in any judgement of financial wellbeing.

Sources - ONS, DCLG, CML, EcoWin, In-house Analysis