

## The Merchant Securities FTSE-100 “Hindsight” Note

This structured note has been designed as a core holding for investors who require diversified exposure to major UK-listed shares. A significant benefit of the structure is the built-in “hindsight” feature. This means that growth over the life of the structured note is measured from the lowest point of twelve monthly observation dates in the first year, greatly reducing the risk for an investor of mis-timing the point of entry. This is combined with a 90% capital protection and enhanced returns of 140% of the index growth (capped at a maximum index growth of 59%).

### Investment objective

The Merchant Securities FTSE-100 “Hindsight” Note offers investors leveraged exposure to the FTSE-100. The hindsight aspect is particularly valuable in the context of the current volatile markets, as it significantly reduces the risk of timing of the entry of an investment. The product also gives investors the opportunity to signal their conviction of an increase in the index by putting just 10% of their initial capital at risk while having 90% of the capital protected as a guard against any long-term downturn in the economy.

Market estimates the dividend yield on the FTSE-100 to be 4.4%. However, with the slowdown in the economy and higher input costs, earnings are expected to come under pressure: several companies have already cut their dividend forecasts. This product offers the equivalent of growth in the FTSE-100 at 10.6% per year over the life of the product (10.6% compounded for six years gives a maximum return at maturity of 83%). This compares very favourably with performance in the recent past: over the last six years the FTSE-100 has increased by an average of 3.5% per annum, though past performance is not an indicator of future performance.

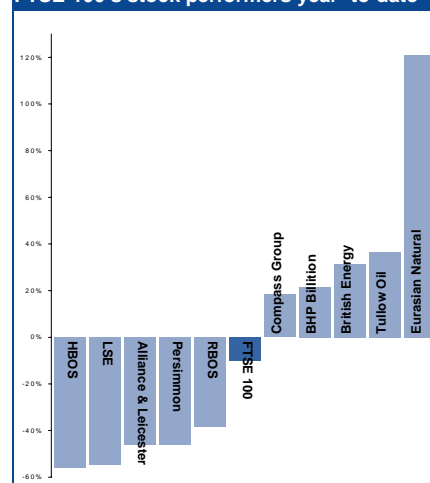
The FTSE-100 is the most quoted UK stock market indicator, consisting of the 100 largest companies, by capitalisation, listed on the London Stock Exchange. The index represents approximately 81% of the capitalisation of the whole London Stock Exchange. Currently the index includes companies such as Vodafone, Marks and Spencer and BP.

The companies included in the FTSE-100 are reviewed quarterly. Companies from the FTSE-250 (the index of the next biggest stocks) are promoted to the main index should their market value place them in the top 90 stocks of the FTSE-100. A company would be relegated to the FTSE-250 if it had fallen to 111<sup>th</sup> or below when ranked by market value. This means that over the life of the product, the constitution of the underlying index will change, but the basket is always maintained at 100 stocks. The FTSE-100 is not constrained by an industry representation requirement, so the sector weightings of the underlying will also fluctuate during the life of the product.

The following chart shows the twelve month relative performance of the FTSE-100 against the S&P 50 and the DJ Euro Stoxx 50. Although the

Indicative terms	
Risk	Low
Underlying	FTSE-100
Offer Price	100p
Nominal Value	100p
Denomination	£ sterling
Minimum investment	£1,000
Secondary market size	£1,000
Initial valuation date	10 <sup>th</sup> July 2008
Note issue date	24 <sup>th</sup> July 2008
Maturity date	24 <sup>th</sup> July 2014
Term	6 years
Index initial valuation	Lowest of 12 observations
Index yield	4.4%
Issuer	Morgan Stanley
Website	<a href="http://www.morganstanleyiq.co.uk">www.morganstanleyiq.co.uk</a>

### FTSE-100's stock performers year- to-date



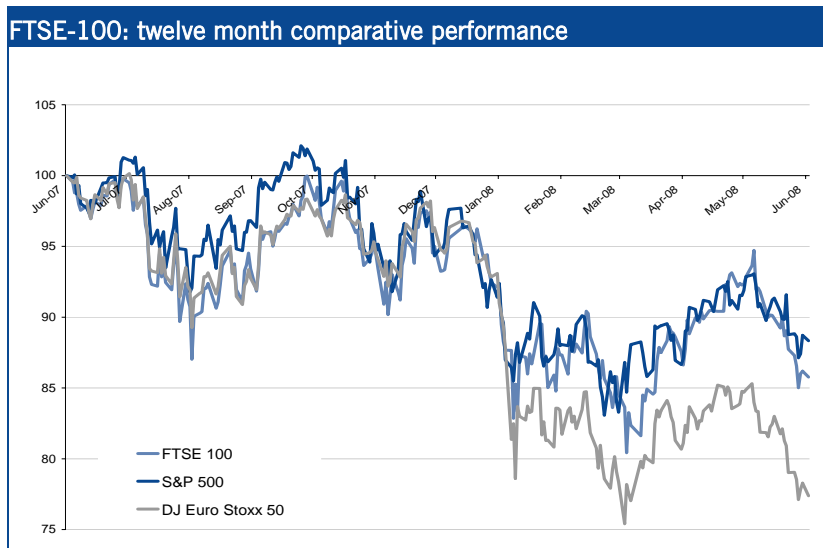
Source: Bloomberg

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chart shows the three indices are correlated, it also shows that the recent market volatility is less pronounced in the FTSE-100.



Source: Bloomberg

### Our view

The UK economy is facing a testing time ahead. There are convincing arguments on both sides on whether the Bank of England should cut or raise rates; the housing market looks vulnerable and yet there are significant external inflationary pressures. This gives rise to a substantial risk of recession in the UK.

Given the current macro-economic conditions, large-cap stocks are favoured. Defensive companies with stable earnings and a strong balance sheet could put in the best performance, and these are the foundation of the FTSE-100 index. The range of sectors included in the index allow the investor to have exposure to any given sector at the point in the cycle where its performance is best; this year the FTSE-100's performance has been driven by the commodity and energy stocks, which represent 33% of the index.

By focusing on the FTSE-100, investors benefit from factors such as clear and detailed reporting by companies, a time-zone overlapping Asia and America, as well as a broad degree of internationalisation. The latter provides some geographical diversification in the stream of underlying earnings, without the need to invest in securities denominated in currencies other than sterling.

*Large-cap, defensive stocks with strong balance sheet are favoured.*

*FTSE-100 benefits from international diversification*

### Investment case

Almost a year ago, the credit crunch began have its first impact, affecting the housing and financial sectors in the first instance. The tightening of credit conditions and the downturn in house prices are now beginning to feed through to the British consumer.

Mortgage approvals fell to just 58,000 in April, a consecutive month-on-month decline, and the lowest level since records began in 1993. A consequence of the drop in mortgage approvals has been a fall in house

*Consequences of the credit crunch have filtered down to the individual consumer level.*

prices with Nationwide reporting a record year-on-year decline of 4.4% in May.

Tightening of credit conditions and concerns over the housing market have made consumers increasingly cautious, but also contributed to an increase in unsecured borrowing. Disposable income will remain under pressure unless there is a significant reduction in interest rates, which is unlikely in the context of current inflationary pressures. Major retailers such as Marks and Spencer have warned that they expect a weaker trading in the second half of 2008.

The UK government has conceded that the UK economy is slowing, with the Treasury's estimate of UK GDP in 2009 being between 2.25% and 2.75%. Most analysts are much less optimistic even than this, with the consensus estimate of growth at 1.7% (source: *Bloomberg*).

Banks such as RBS, HBOS and Bradford & Bingley have all had had rights issues to repair their balance sheets due to the fall-out from the credit crunch. As slower growth is anticipated, further write-offs from both mortgage and business lenders remain a possibility, which could lead to further downward pressure on share prices in the financial sector.

The economic risk is significantly compounded by the danger of a significant pick-up in the rate of UK inflation.

The Governor of the Bank of England recently stated that he expects inflation to rise above 4% before the end of 2008. So far, inflation has been driven by external factors; the Bank of England has no control over the rapid rise in food or energy prices. However, with the first trade union having struck a pay deal worth 14% (Shell tanker drivers), there is a growing fear that further pay deals will exacerbate the inflationary pressure. Inflation should recede with the slowdown in the economy, but this effect may not occur immediately. The current risk thus becomes one of "stagflation", the simultaneous occurrence of stagnation in growth, with rising rates of inflation.

Taking all of this into adjustment it is correct to maintain a defensive stance. There are concerns over companies' earnings both from weakening demand and inflationary pressures. Non-cyclical stocks with sustainable, stable, visible earnings are favoured. Although the domestic picture is not bright, the fall in sterling has made exporters look more competitive and the nature of the FTSE-100 gives it a considerable exposure to foreign markets.

The concerns above are not likely to be addressed in the short-term; however an economic slowdown is only part of the economic cycle. Over the mid-term we expect some of the hardest-hit sectors to rebound, rewarding the patient investor.

### The structure

The Merchant Securities FTSE-100 "Hindsight" Note is an option-based structured product. The note consists of a zero-coupon bond, which provides the capital protection, and a basket of put options and call warrants. The net effect to the investor is the initial investment is protected up to 90% with leveraged upside potential of 183%.

The product reduces timing risk by having the ability to select a minimum value for the initial valuation point. At expiration risk is reduced by averaging the final valuation point.

Rather than taking the initial index level at the launch date of the product, the initial index level is taken as the lowest level of the index occurring on the tenth day of any calendar month for the first twelve months of the

*Treasury GDP estimates above independent forecasts.*

*Food and energy inflation has been beyond our control....*

*...however, wage inflation is not*

*Weakening demand and inflation worries is putting pressure on earnings expectations.*

*The product gives an optimum entry point to the market*

product. Significant value is added for the investor as a result of this feature, whereby the initial valuation level will be taken as the lowest of twelve points during the first twelve months of the product, rather than a fixed point of reference. If it were based on the FTSE-100 levels year-to-date, the product would take its initial index level as that at of 10<sup>th</sup> March 2008, when the FTSE-100 had fallen to 5,629.

The closing level of the index is taken as the average of the tenth day of the month over each of thirteen calendar months prior to expiration of the product. The method provides further benefit to the client as it reduces the impact (and risk) of a market dip close to the maturity date. If the FTSE-100 decreases in value over the final thirteen months of the product life, this averaging will give the investor a higher final index level than would be achieved by using the expiration date as the reference point. This also has the effect of limiting growth if the market is rising during the final thirteen months.

*Final averaging reduces the investor's risk*

Total redemption at maturity from £1,000 invested			
Final index level as a % of initial index level	Capital return at maturity	Growth return at maturity	Total return at maturity
40%	£900	-	£900
60%	£900	-	£900
80%	£900	-	£900
95%	£900	£50	£950
100%	£1,000	-	£1,000
105%	£1,000	£170	£1,170
120%	£1,000	£280	£1,280
140%	£1,000	£560	£1,560
160%	£1,000	£826	£1,826
180%	£1,000	£826	£1,826

Source: Merchant Securities

At maturity, the zero-coupon bond will have appreciated in value to 100% of nominal capital. The warrant will then have a value of 140% of the upside performance of the index, capped at 59% above the initial index level. If the index has appreciated 20%, the growth return is 28%. This, together with the 100% capital protection, will then give a final redemption value of 128% (100% + 28%).

Should the index have appreciated over 59% of the initial index level the total return remains at 83% of the original investment (upside capped at 59% with participation at 1.4 times and 100% of capital returned).

In the case where the final index level falls below that of the entry level, the investor is still protected to a minimum of 90% par value at maturity. If the final index value is between 90% and 100% of the initial index value, the investor receives a return equivalent to the one-for-one fall in the index. This means that if the final index value were at 99% of its initial valuation point, the investor would receive £990 from each £1,000 invested.

*Losses are limited if the index has fallen over the term of the Note*

As this product can be traded, profits can be taken at any point prior to maturity.

### The downside

Because the note is constructed using long-dated options, the full leverage does not kick in at the start of the Note, but gradually builds up during the

Note's life. This is the normal profile for almost all structured products. It means that an investor should normally expect a structured note based on options with geared participation to underperform in the beginning of its life. The magnitude of underperformance is a function of the call option's delta (the option's price sensitivity to the underlying instrument).

It is emphasised that the product will not, therefore, track the FTSE-100 in the early stages of its life. Before the product reaches its maturity, its price is a function of the zero-coupon bond and the call option. The zero-coupon is bought at a deep discount and appreciates over the life of the product to 100% of the initial capital invested. The performance of the call warrant is dependent upon the underlying index value, volatility, interest rates and time to maturity.

If investors seek to realise their investment before maturity they may receive less than par value; the full extent of the call features are not realised until maturity, thus structured products are seen as more of a buy-and-hold investment strategy.

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## Product details

### Secondary market

Morgan Stanley provides full intra-day secondary market with a bid-offer spread of 1%.

Indicative secondary market prices are available at:  
[www.morganstanleyiq.co.uk](http://www.morganstanleyiq.co.uk)

### Taxation

It is our opinion that the final return of this product will be treated as a capital gain and is therefore subject to capital gains tax as opposed to income tax. You should consult your tax and accounting advisors to the extent you deem necessary. This note can be used as an investment within a SIPP, ISA or SSAS structure.

### Fees and expenses

Merchant Securities Group Limited dealing and management fees are not included and will be applied according to our standard charges for equity investments. Merchant Securities Group Limited will charge the issuer a fee for the design and set-up of the structured note, which will be the equivalent of 1% per annum of the issue amount. This has been taken into account in the terms of the product. Details of fees and charges are included in our standard Terms of Business.

## Important Notice

### Specific risks

#### Capital Protection Risk

Capital protection will exist on the basis that the investment is held until redemption. There exists a counterparty risk on the zero-coupon bonds held by the Note which will be issued by one or more financial institutions which attract an A+ rating. There is the possibility that an issuer could face financial difficulties resulting in failure or other default. To put this in context, Allied Irish Bank, Credit Suisse and Fortis are other financial institutions with the same credit rating. Capital protection is calculated on the nominal value of the note, and not on the purchase price, which may be higher or lower than the nominal value.

#### Exit risk

The secondary market price of the securities will depend on many factors, including the value and volatility of the underlying indices, level of the underlying indices at any time on any day and time left until the maturity of the securities, interest rates, the dividend rate on the stocks that compose the underlying indices, time remaining to maturity and the creditworthiness of the issuer. Therefore the holder may receive an amount which may be less than the then intrinsic market value of the securities and which also be less than the amount the holder would have received had the holder held the securities through to maturity.

#### No shareholder rights

A holder of warrants will have no beneficial interest in the constituents of the underlying indices or any voting rights and will not have the right to receive dividends or other distributions with respect to the stocks that compose the underlying indices. The reference levels of the Index as outlined in the terms and conditions will determine the pay-off of the bond.

#### No interest

Unlike ordinary debt securities, the securities do not pay debt interest. The return of only the principal amount will not compensate the holder on the securities for the effects of inflation and other factors relating to the value of money over time.

#### Indicative terms

All terms in this research note are indicative and can change at any time until the strike date. Final terms will be announced on the valuation date.

#### Credit risk

The holder of the notes will be exposed to the credit risk of the issuer.

#### Hedging risk

On or prior to and after the trade date, each issuer, through its affiliates or others, will likely hedge its anticipated exposure under the securities by taking positions in the stocks that comprise the underlying indices, in option contracts on the stocks that compose the underlying indices or positions in any other available securities or instruments. In addition, each issuer and its affiliates trades the stocks that compose the underlying indices as part of their general businesses. Any of these activities could potentially affect the value of the underlying indices, including on the determination date, and accordingly could significantly affect the payout to holders on the securities.

#### Liquidity risk

The notes will not be traded on an organised exchange. Although the dealer and the placing agent will make a secondary market in the notes on a best efforts basis, the liquidity of the notes may be limited. The liquidity of the note reflects the liquidity of the securities that underlie the underlying equity.

#### Adjustment and disruption risk

The sponsor of the index can add, delete or substitute stocks constituting the respective index or make other methodological changes that could change the value of the respective index without regard to the interests of holders of the securities. Any of these decisions/determinations may adversely affect the value of the securities and may result in the investor receiving a return that is materially different from that received if the event had not occurred.

#### Underlying sponsor risk

The sponsor of each underlying index is not an affiliate of the issuer or its affiliates and is not involved with this offering in any way. Consequently, the issuer has no ability to control the actions of the sponsor of each underlying index, including rebalancing that could trigger an adjustment to the terms of the warrants.

### Index risk

The warrants will be exercisable at an amount determined by the reference to the performance of the underlying index and such performance will therefore affect the nature and value of the instrument return on the warrants. The warrant holder and prospective purchasers of warrants should conduct their own investigations and, in deciding whether or not to purchase warrant, prospective purchasers should form their own views of the merits of an investment related to the underlying indices based upon such investigations and not in reliance on any information given in the term sheet.

### General Risks

**The value of any securities or financial instruments mentioned in this report can fall as well as rise and therefore, upon withdrawal, you may receive back less than the full amount invested. Transactions including those involving options and other derivative instruments can give rise to substantial risk and are not suitable for all investors. The value of units in collective investment schemes that use derivatives such as options and futures may, under certain circumstances, be more volatile than non-derivative schemes and therefore, upon withdrawal, you may receive back substantially less than the full amount invested. Foreign-currency denominated commodity contracts and financial instruments are subject to fluctuations in exchange rates that may have a positive or adverse effect on the value, price or income of such securities or financial instruments. In extreme circumstances you may receive nothing back. Changes in rates of exchange may have an adverse effect on the value or price of investments in sterling terms. All investments may fluctuate in value. Past performance is no guarantee of the future performance of investments. You should carefully consider in the light of your financial resources whether investing in stocks, shares or collective investment schemes is suitable for you.**

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