PRU Global Basics Fund
3Q06 Fund Management Update

Following a strong first half of the year, the performance of the PRU Global Basics Fund suffered in the third quarter against a market background characterised in particular by an extremely weak mining sector. The fund delivered a return of -1.7% over the three months, compared with 1.2% from the fund's FTSE composite benchmark and 2.3% from the IMA Global Growth sector average*.

This article examines the causes of this relative performance. It looks also at the measures taken by fund manager Graham French to reposition certain aspects of the portfolio, whilst retaining its long-term core of asset-rich companies operating in fundamentally sound industries.

Review – commodity stocks

Following the surge in prices of metals and other commodities in recent years, increased investor concern over the valuations and outlook for companies in this sector resulted in rising volatility and sharp declines in their share prices. This correction has been seen by some as a setback to the 'stronger for longer' thesis by which growing demand, together with under-investment in supply, are expected to keep commodities prices rising for years to come.

The view shared by Graham French and Matthew Vaight (M&G's mining analyst) is, however, that after such a strong run in the shares of those companies, the correction has simply brought many share prices back to levels more reflective of underlying commodity prices.

While both Graham and Matthew remain firmly of the belief that the supply/demand dynamics for certain metals will remain supportive of prices over the long term, they take a more realistic view than some of the more zealous proponents of the 'commodities super cycle' theory. As the manager puts it, "stronger for longer does not mean stronger forever".

In addition, not all commodities or related companies necessarily display strong fundamental characteristics. We believe it is important to differentiate between metals such as nickel and platinum, for which supply is being sensibly managed, and those such as aluminium, where the supply response from producers has been less conservative. The mining holdings in the PRU Global Basics Fund fall overwhelmingly into the former camp.

Importantly, individual companies remain the key focus of the fund. Graham French continues to seek out and invest in reasonably valued companies with strong management teams and valuable assets that are operating in areas supported by sound economic fundamental characteristics.

*Performance calculations are based on the underlying M&G Global Basics Fund.

Graham cites the examples of Cameco and Rio Tinto to illustrate the wide divergence in the quality of companies within the commodities sector. Cameco is a Canadian uranium producer which has benefited from positive sentiment towards a ‘hot’ sector, but for which the market is pricing in returns way above those the company has ever managed to achieve in the past. For Rio Tinto, in contrast, the market’s pricing of the company reflects a major decline in returns in coming years, despite the fact that Rio Tinto is one of the world’s largest mining companies with high quality, diversified assets in extremely well supported natural resources areas.

Review – performance drivers

Against this market background, we set out below the key specific influences on fund performance in the third quarter.

Negative influences

Performance was hurt by positions in US coal mining groups Peabody Energy and Consol Energy. While both stocks had previously made strong contributions to the fund, shares in both companies were hit by the decline in natural gas prices over the past few months. Falling natural gas prices have the effect of eroding the cost-attractiveness of coal as an alternative energy source for power generation. The manager nevertheless maintains his positive opinion of both companies, based primarily on the quality and scope of their assets, and also on the growing strategic importance of coal as a more secure, less geopolitically sensitive energy source, particularly in the US.

One area of concern with regards to the fund’s coal holdings has been the lack of control on the supply side, with some companies showing a less disciplined supply response than we would like to see. We have been impressed recently, however, by signs that some producers are taking steps to reduce production and, in some cases, also production capacity.

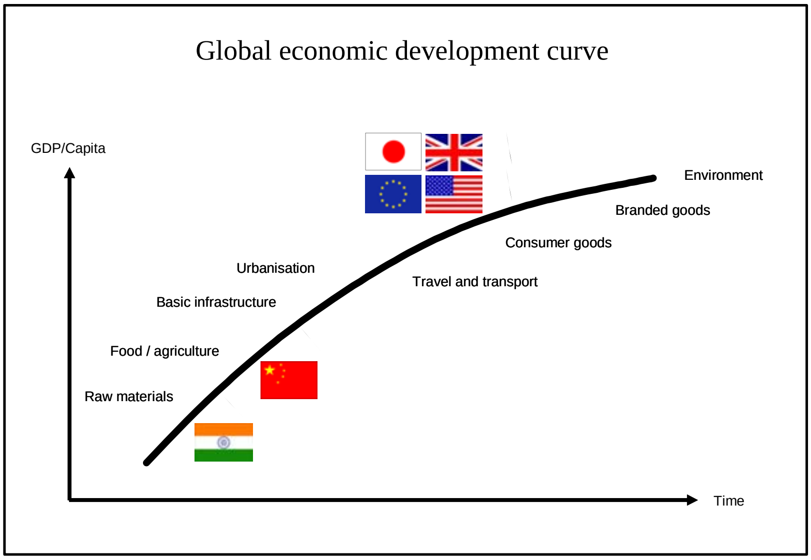
Other company detractors to fund performance during the quarter included diversified mining group Rio Tinto, Australian steel producer Bluescope Steel, and South African platinum miner Lonmin. All three stocks succumbed to broadly-based weak sentiment towards commodities stocks, together with profit-taking by investors following a long period of strong performance.

Positive influences

Strong returns over the quarter came from companies in a range of sectors; including Sims Group (metal recycling), First Quantum Minerals (African copper miner), Coles Myer (Australian retailer, recently the subject of a bid), Arkema (speciality chemicals producer, spun out of Total), and K&S (potash producer, whose returns have been driven by global demand for fertilisers). All had made strong contributions to performance, indicating the diversity of sources of performance on which the fund is able to rely.

Outlook and fund positioning

While Graham French continues to hold selected mining companies at the core of portfolio, the PRU Global Basics Fund has been shifted gradually in recent months along what the manager terms the ‘curve of global economic development’, which reflects the advance up the consumption value chain resulting from economic development. This is illustrated in the chart overleaf.



Source: M&G Investment Management, November 2006

Commodities

Demand at the more 'basic' end of this curve continues to be well supported by the structural shortage of global raw materials; the fund will therefore continue to have a core focus in this area. Within this commodities component, however, there has been a gradual shift away from mining companies involved in the extraction of 'hard' commodities (eg metals and minerals) and towards 'soft' commodities (eg agricultural products).

The latter area encompasses two main types of company: those such as Corn Products and Agrana, which are involved in growing and/or processing products such as corn and sugar, which are increasingly used in the production of biofuels as alternatives to oil; and those such as Agrium and K&S, which are producing fertiliser products to make this process more efficient. Both types of company are driven by the increased pressure being placed on agricultural production by a growing global population and the consequent intensification of arable land use.

Other areas

The major shift in the overall portfolio, and one that is likely to continue over the coming months and years, has been away from commodities and towards consumer-related areas, in particular the 'emerging consumer'. This can be represented by a movement along the global economic development curve.

As economies such as China and India grow, there is a shift in aggregate demand by consumers away from basic requirements for raw materials and food, up through the need for housing and other infrastructural development, and increasingly towards discretionary items ranging from toiletries and packaged food to western-branded goods and foreign holidays. The development of the PRU Global Basics Fund has mirrored, and will continue to mirror, this shift.

Company holdings that represent these themes along the economic development curve include Wienerberger and Holcim (infrastructure/building), Danone and Colgate Palmolive (consumer products), Rolls Royce and EADS (travel and transport), and VF Corp and The Cooper Companies (western branded goods).

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