Newsflash
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PRUDENTIAL
PORTFOLIO MANAGERS

Prudential Inflation Plus Fund and recent market volatility

The last two months have been very trying times in global markets. Our Inflation Plus Fund has historically held up well in times of such volatility, however, the last two months have been disappointing for investors. Since inception in July 2001, the largest drawdown in any one calendar month was just under 2%. In September this year, the drawdown was just over 4% followed by October with a drawdown of 3.4%.

The Fund has always tried to limit volatility through sensible asset allocation rather than the use of derivatives. So, in the light of the last two months, we believe that we need to confirm our process and how we deal with times of extreme volatility.

It is true that the negative return shown by the Fund is a lot less than some of the extremes experienced within the underlying asset classes during September, with the JSE All Share down 13.2% and Resources down 21.8%. But this is not the sort of "comfort" the investor is looking for. So what were the real drivers of the negative returns within the Fund and what should investors expect going forward?

The Fund is built on a two step process:

- Establishing a long-term strategic asset allocation benchmark
- Taking tactical positions around this benchmark when **valuations** in the market warrant such a move (note: valuations not sentiment).

The long-term strategic benchmark together with the indicative range per asset class is set out in the table below.

Asset Class	Strategic benchmark	Indicative ranges
Equities	30%	10% to 35%
Property	10%	0% to 20%
Bonds	20%	0% to 30%
Inflation-linked bonds	35%	10% to 75%
Cash & FRN's	5%	0% to 40%

Going into September, our equity allocation position was not very aggressive, only 1.5% overweight (i.e. 31.5% v 30%). The biggest underweight was inflation-linked bonds at -20% (which at a real yield of only 2.5% appeared unattractive), but this was somewhat offset by a large overweight in cash at +15%.

Looking at a detailed attribution analysis the real problem was not only due to the exposure to equity, but also the nature of that equity exposure. We have, historically, always held a large rand-hedge weighting within our Inflation Plus Fund's equity exposure and this has tended to act as a sound "buffer" in times of rand weakness. Unfortunately, during most of September this relationship did not hold; as the rand weakened, so many rand hedges (particularly resource stocks) seemed to weaken even more.

The attribution analysis also shows that listed property subtracted value, but this had less of an impact than the resource exposure.

What do we do now?

Those who attended our recent road-show with our international speakers should recall that we are convinced that the recent extreme movements, particularly in equity markets, are over done. In many ways it's a classic "fear episode". We believe that many equities are currently offering value not seen for many years. This does not mean that they can't get cheaper, but the opportunity to recover and make good returns over the medium term is exceptional.

As Warren Buffet said recently:

"Be fearful when others are greedy, and ***be greedy when others are fearful***. And most certainly, fear is now widespread, gripping even seasoned investors." (New York Times, 16 October 2008)

Many will have been very tempted to act out of fear after the past two months and simply reduce volatile assets in favour of cash. But this would only lock in losses and severely limit the potential for recovery. Over the past six weeks we have, therefore, been buyers of equity (particularly industrial rand hedges) which means that the current asset allocation for the Fund is as follows:

Equity	35.5%
Listed property	13.0%
Bonds	19.5%
Inflation linked bonds	15.5%
Cash	16.5%

So, we have put our money where our mouths are! Yes, it has taken some "emotional resilience" (or guts) to do so, but we are convinced that our clients will benefit in the medium term. Already we have seen some stocks rally, but it is still early days.

We are convinced that our investors will reap the benefits of our valuation-based decisions. It may take a little time, but those who show that same emotional resilience, will be rewarded.