

PRUDENTIAL

**QUARTER
THREE
2007**

IN THIS ISSUE

**An update from
Martin Brookes**

Market Review

Our current views on the
global economy and
investment markets

Review of Property

Asset Allocations Tables

For Adviser Use Only
Not Approved For Use
With Clients



WITH-PROFITS FUND

Investment Review from Martin Brookes, Director of Portfolio Management

INVESTMENT REVIEW FROM MARTIN BROOKES, DIRECTOR OF PORTFOLIO MANAGEMENT AND PORTFOLIO MANAGER OF THE PRUDENTIAL WITH-PROFITS LIFE FUND

QUARTER THREE 2007

THE COMMENTARIES IN THIS REPORT REFLECT THE VIEWS OF BOTH MARTIN BROOKES AND OUR FUND MANAGERS AND SHOULD NOT BE TAKEN AS A RECOMMENDATION OR ADVICE AS TO HOW ANY MARKET IS LIKELY TO PERFORM. THIS IS FOR ADVISER USE ONLY.

ABOUT MARTIN BROOKES



Martin is a Director of Portfolio Management and a member of the Portfolio Management Group (PMG), which is a team of 15 investment professionals responsible for the day-to-day management of Prudential insurance funds and Prudential unit-linked life and pension products. He is head of the Portfolio Management team.

He has over 20 years investment management experience and holds a BA and MA in Politics, Philosophy and Economics from Oxford University.

AN UPDATE FROM MARTIN BROOKES

Welcome to the Q3 2007 update on the Prudential's With-Profit fund, which covers April – June 2007.

The Prudential With-Profits Life Fund has had a good 6 months to end June 2007. Continued strength in equities has helped lift the total return to 5.8% (gross return on underlying assets to end June 2007) which represents an out performance of both our internal benchmark and, we believe, the average competitor return which we calculate at circa 4.5%. This is more good news in addition to the recent WM 2006 Life Fund survey which showed the Prudential Fund topping the With-Profits Life Fund survey over 2006. Key details from the longer running Life Funds survey are shown below.

	Prudential %	Median %	Funds in Survey	Rank
1 year	12.4	10.4	19	1st
3 years (annualised)	15.3	12.5	19	1st
5 years (annualised)	10.4	7.3	19	1st
10 years (annualised)	10.1	8.1	19	1st

CDS CREDIT HEDGE

Given the volatility that has been seen in the credit markets in recent days (I'm writing this on the 2nd August) in addition to the comment on markets and strategy described below I'd also like to update you on a substantial transaction as reported in the FT today that we implemented in June.

In late June the Portfolio Management Group (PMG) bought Credit Default Swap (CDS) protection on a substantial portion of the corporate bond investments held within the Prudential With-Profits Fund. The rationale for the hedge is that over the last four years credit spreads have tightened significantly particularly on BBB and high yield i.e. corporate bond valuations have risen. Although to some extent this is understandable – the environment has been extremely benign in

terms of actual default – the increasing leverage in connection with many private equity transactions combined with decreasing covenant protection has raised the likelihood of a worsening default outlook. Our view is that credit spreads could widen significantly if that were to become apparent. Given the substantial returns the Prudential With-Profits Fund has experienced since buying the bulk of its corporate bond exposure in 2000 – 2001, it seemed sensible to reduce our risk and lock in some of those gains.

The nature of the hedge can best be thought of as buying insurance i.e. the fund will pay an annual premium to protect against credit spread widening. Economically it has the effect of shifting a credit exposure into that of a swap, which for our purposes, we can think of as a risk free asset.

We have chosen to hedge about 25% of the sterling and European BBB corporate bond portfolio and all the sterling and euro high yield exposure, and the entire US dollar high yield. Across all the Life With-Profits portfolios the total notional hedge size is approximately £4 billion. We chose not to hedge the US investment grade portfolio because the 6% switch into bonds out of equities in April/May last year was implemented predominantly by buying a US dollar bond portfolio benchmarked against the Lehman Aggregate index. This is an AA rated benchmark, so in effect, a substantial reduction in risk in US bonds had already taken place.

CDS derivatives are available either on individual bonds (single names) or on a representative portfolio or index of available liquid bonds in a given credit band. Rather than hedge each name in the portfolio we chose to use the large and extremely liquid market in indices. Specifically we

bought protection on the iTraxx Investment Grade and iTraxx Xover indices to hedge respectively the investment grade and high yield European portfolio and the CDX HY index to hedge all the US high yield portfolio. Using the index means we implemented quickly with little market impact and allows the fund to benefit if our own credit skills as applied to the underlying portfolios result in a better performance than the broader market.

The overall impact of the hedge has the effect of significantly reducing expected default on the fixed income portfolio.

Given that the concerns in credit have also caused some volatility in equity markets I'd like to reiterate the comment on equity valuations below in the main commentary – we remain very comfortable generally with equity valuations and the current equity backing ratio in the fund. The real asset exposure was 71.9% at end June which is little changed from the start of the year.

MARKET REVIEW

Our current views on the global economy and investment markets

Overview: Q2 2007

The global economy remained in a healthy state over the second quarter of 2007; economic growth continued to expand, inflation was under control and company earnings were still surprising on the upside. Against this background, bond and equity markets reacted very differently. Equities continued to build on the gains already seen this year – with many markets reaching new peaks – whilst bonds fell sharply to levels not seen for many months.

EQUITY INDEX TOTAL RETURN (IN STERLING TERMS)

INDEX	QUARTER 1 TOTAL RETURN	1 YEAR TOTAL RETURN TO END JUNE 07
S&P 500	3.9%	11.2%
FTSE ALL SHARE	4.5%	18.4%
FTSE WORLD EUROPE EX UK	7.0%	25.9%
TOPIX (JAPAN)	-3.2%	-3.5%
FTSE W ASIA PACIFIC EX JAPAN	10.5%	30.3%

Perhaps the biggest surprise to expectations occurred in the US where there was a renewed upward momentum in the pace of economic growth. Despite forecasts that the slump in the housing market would cause the US consumer to stay at home, consumer spending levels have been supported by low unemployment levels and higher wages. A pick up in manufacturing activity also pushed growth higher. The stronger US economy is in sharp contrast to the fears expressed at the end of March which depicted problems in the US sub-prime mortgage market escalating to send the US economy into recession. Instead, high capacity utilisation levels have renewed concerns over inflationary pressures and US interest rates were kept on hold as the US Federal Reserve (Fed) continued to balance the risks between inflation and growth.

Meanwhile, the European economies continued to go from strength to strength. Germany, in particular, was the key driver of economic expansion in the Eurozone as soaring exports and tight cost controls

resulted in higher company profits. This robust growth led to higher interest rates when the European Central Bank raised short-term rates to a six-year high of 4%, remaining vigilant about inflationary pressures. The UK economy also continued to boom with few signs of the housing market weakening or consumer spending slowing. In response to this, UK interest rates were also raised by 0.25% to 5.5% as the Bank of England tried to dampen demand.

In the Pacific Basin too, the story remains one of expanding economic growth, spurred by exports and consumer spending. The ongoing strength in many of the Far Eastern economies led to the authorities counteracting potential inflationary risks by either gradually allowing their currencies to appreciate or by tightening monetary policy. However, in Japan, growth continued to disappoint and deflationary pressures resurfaced. This meant that the proposed increase in Japanese interest rates to 0.5% was, once again, postponed.

MARKET REVIEW – CONTINUED

Overview: Q2 2007

Despite interest rates trending upwards, equity markets were comforted that this was in response to higher growth, rather than inflation, which was perceived as good news for company profits. Investors continued to be attracted by relatively low price/earnings ratios and merger and acquisition activity remained buoyant. With this support, global stockmarkets rose strongly with European and US markets touching the highest levels for many years whilst, in the Far East, the majority of markets recorded new highs.

However, for bond markets, it was a different story. Unsettled by the steady drip-feed of stronger than expected US economic data, bond investors realised that cuts in US interest rates were unlikely. As hopes of rate cuts were dashed, US bond prices plummeted dragging European bonds with them. Yields on long-dated bonds rose 0.5% in the US, reaching levels last seen during the oil price surge last summer, whilst yields on 10-year European bonds rose to levels last seen in 2000. Furthermore, investors became cautious about taking credit risk following heavy losses in several high profile hedge funds as the stress in the US sub-prime mortgage market fed through.

This negative sentiment towards bonds did dent the equity markets strong performance initially. Investors became particularly concerned that the rise in long-dated bond yields would choke-off ongoing demand from leveraged buyers, such as private equity investors who were perceived to be one of the major supports for the high level of merger and acquisition activity. These fears proved short-lived and, by the quarter end, equity markets had recovered with investors, yet again, focusing on the benign economic background, reasonable valuations and the strong corporate profit outlook. In the UK commercial property market, however, the first signs of a slowdown began to emerge as the impact of higher interest rates at last appeared to be curtailing the exceptional investor demand, particularly in the retail sector.

Looking ahead, the key dilemma for investors is whether, given the increase in bond yields, equity markets can continue to rise or whether they are beginning to look overvalued in comparison.

Outlook

Despite the continued strength in equity markets, many commentators have been unsettled by the recent increase in long-dated bond yields. Not only do rising bond yields make stockmarkets look more expensive, they also raise the cost of borrowing. Given that the ready availability of cheap money has been cited as one of the major drivers of the global equity bull market over the past year, are equity prices now looking stretched or can they continue to bound ahead?

Turning first to the economic outlook, the global economy seems set to deliver robust growth for the rest of 2007 and into 2008. Consumer spending continues to be a driving force in most economies, investment is picking up, both service and manufacturing sectors are performing strongly and the prospects for company profits look healthy.

However, inflationary pressures remain a worry, especially for those economies, such as the UK and US, where capacity utilisation is high and unemployment is low. Furthermore, the ongoing strength in commodity prices, not just energy and metals but food too, is also of concern since the higher cost of raw materials has the potential to fuel

MARKET REVIEW – CONTINUED

Outlook

consumer price increases. However, the fact that wage pressures remain benign gives some comfort and we do not see inflation spiralling out of control.

Nevertheless, central banks are expected to maintain their bias towards tightening monetary policy for the remainder of the year in response to the strong economic outlook. Therefore, further interest rate increases are anticipated across all of the global regions, with the possible exception of the US where the future direction the Fed takes is more uncertain given the continued weakness in the domestic housing market.

While higher interest rates are not normally considered to be good news for bonds, the fact that we do not consider inflation to be a significant problem suggests that the medium-term environment remains supportive of bond markets. Furthermore, the recent rise in long-dated bond yields has made bond markets far more realistic in their interest rates assumptions. We would now argue that western government bond markets are much nearer fair value now than they have been for many years, especially if, as we believe, consensus inflationary fears are over-stated and interest rates peak sooner than expected.

Of greater concern is the corporate bond market where the yield premium over government bonds remains historically narrow. Signs of stress in some areas of this market have emerged, caused by the fallout from the crisis in the US sub-prime mortgage market earlier in the year. Large losses have been experienced at several high profile hedge funds, and investors are becoming wary about taking on 'low quality' credit risk, preferring the safety of government bonds and higher quality issues. The gloom surrounding credit, particularly high yield, has the potential to increase the yield premium over government bonds.

Meanwhile for equity markets, the economic background remains generally supportive and analysts continue to revise up their earnings forecasts. Despite this equity-friendly environment, investors are concerned that the higher cost of borrowing will deter takeover activity which has been cited as one of the main factors driving the bull market. In particular, there are fears of reduced demand from leveraged buyers, such as private equity companies. At present, these fears appear unsubstantiated. The largest private equity company, Blackstone, recently floated successfully on Wall Street and continues, with its peers, to launch audacious bids for listed corporate giants.

Nevertheless, there are some signs that equity investors may be becoming slightly more risk averse, reflected by the recent superior performance from large cap stocks compared to small and medium size companies. Large cap stocks have lagged smaller companies for several years, being viewed as being less likely to be potential takeover targets. The tables might now be turning with investors happier to invest in more established larger cap companies. The view of many Prudential equity fund managers is that valuations on large cap stocks look significantly better value than on the mid and small cap part of the market.

Over the last twelve months, investors have fretted either over inflation or recession, causing bouts of sharp price changes as market forecasts swung from one scenario to the other. Although bonds have had a recent sharp set-back, this is not surprising since they have blatantly been overvalued for some time. However, the economic environment appears supportive to both asset classes, especially now markets have factored in all but the most pessimistic interest rate outlooks.

REVIEW ON PROPERTY

Market Outlook

UK PROPERTY

Returns to UK property are decelerating as yield compression slows and the recent rate of capital value growth moderates. Current three month returns are now hovering around 2.3%. This compares to 3.8% in Q4 2006. Twelve month returns have now moderated to 13.9% from 18.1% in December 2006. IPD equivalent yields have fallen by a mere 5 bps in the first five months of 2007 compared to nearly 60bps over 2006, and 80bps the year before. Retail yields are now essentially flat and may even be rising in some secondary markets.

By contrast, the pace of rental growth continues to increase. Driven by a continuing strong central London office market recovery, it has now risen to a 12 month rate of 3.8%. Office rents have risen by 13% in the City of London and by 16% in the West End in the last 12 months. By contrast, rental growth remains around 2.5% in retail properties and around 1.5% in industrials.

The consensus of market commentators, as measured by the Investment Property Forum, is expecting a slowdown in UK property total returns in 2007 to 9.1%. It is forecasting rental growth for 2007 to be 4.1% and yields to be broadly stable. However, the general expectation is that yields will move out in 2008 and 2009 leading to UK property total returns for 2008 and 2009 at around 5%, with offices the best performing sector and retail the worst.

Given the market is increasingly dependent on rental growth (rather than further yield compression) for its performance, the office sector in central London is the market currently most favoured by investors and is attracting the lion's share of invested capital.

Market turnover remains high by historical standards. Overseas and private investors remain active, especially from the US, Middle East and Australia. However, the range of investor interest is diverse with the top 10 investors in 2006 constituting only 22% of turnover. Major sellers currently are owner occupiers and 'profit taking' private property companies.

Concern over pricing of secondary property assets is rising. As the combination of increased borrowing rates and falling yields squeezes leveraged investors out of the market, and investor interest turns more to growth-oriented prime markets, there is fear that the historic yield gaps between prime and secondary markets will re-assert themselves, damaging the returns on secondary properties.

In a desire to achieve better returns and find quality stock, development is proving increasingly attractive for investors and, as a result, speculative development is now on the rise.

Prudential Property Investment Managers Limited (PRUPIM) remains of the view that an adjustment to the pricing of UK property is likely in the medium term but that it will be relatively gradual. There is still a substantial weight of capital seeking to purchase property assets and there is no current suggestion of any impending collapse in rental values. As such, in common with the consensus, PRUPIM feels that yields will remain broadly stable in 2007 but then begin to rise steadily and modestly in 2008 and 2009.

INTERNATIONAL PROPERTY

Economic growth and a generalised below average level of development in recent years have triggered real rental growth in many international property markets. Property is also still seen as a 'safe haven' asset for many investors, offering reasonably high income returns without the volatility of some other asset markets. Given this background, it is not surprising to see the recent very strong demand for investment property around the world continuing. A surfeit of demand over investable supply has driven yield compression around the globe. However, high prices are now tempting increasing amounts of stock onto the market. This increased level of investable assets, coupled with a narrowing spread between property yields and interest rates, is helping slow the pace of yield compression.

In search of higher returns, capital is moving out along the risk spectrum into alternative property sectors, emerging country markets and generally more secondary locations. As in the UK, development is on the increase.

The scale and pace of globalisation in the world's property markets continues to be remarkable. Driven by investors' desires to gain better returns and/or better diversification than domestic markets can provide, cross-border investment within and between global regions continues to break historic records.

PORTFOLIO STRATEGY

UK PROPERTY

In expectation of the slowdown in property market returns, we have taken steps over the last 18 months to bring down the exposure to UK property through net disinvestment of just under £1.8 billion. In addition, £200 million of exposure has been sold through the newly developed property derivatives market. The value of the Portfolio in the UK market now stands at just under £9 billion.

Whilst sales have taken place across all sectors of the property market, they have been skewed in favour of bringing down the Portfolio's retail exposure from an overweight to an underweight position. This has led to the sale of a number of shopping centres (Luton, Wolverhampton, Uxbridge, Bradford, Redhill and Coventry) for around £735 million. Other retail sales have included two blocks of property on Oxford Street, London, W1 for just under £245 million. This has positioned the Portfolio well at a time when the performance of retail property is poorer than that of offices and industrial. Other notable sales that have taken place over the period include: 1 Knightsbridge Green, London SW1 (£200 million), City Centre House, Birmingham (£161 million) and Building 3 Minster Court, London, EC3 (£112 million).

Alongside the sales programme, we continue to actively manage the Portfolio. The most notable projects include the major extension to the Arndale Centre, Manchester (where the final phase opened in September 2006) and the development of offices at Paddington (let to Rio Tinto) and Finsbury Circus.

We also continue with the development of, or work up of plans for, further phases of a number of business and industrial parks around the UK. We also acquired interests in a number of strategic land holdings to provide a supply of future development opportunities. Expenditure on development, refurbishment and asset management initiatives in the UK totalled £240 million over the 18 month period.

The UK Portfolio is very well diversified containing over 300 properties, the largest of which represents just over 6% of the value of the Portfolio with only eight other properties individually representing more than 2% of the Portfolio. Similarly, the rental income stream for the Portfolio is well diversified across numerous tenants with the largest accounting for just under 6% and only five other tenants accounting for 2% or more of the Portfolio's income.

INTERNATIONAL PROPERTY

In the period, a further £230 million was invested in property outside the UK which concluded the £1.3 billion planned diversification into international property which commenced just over five years ago. Around 50% of the assets are held in 16 investments in North America, around 25% in Europe (held in three third party funds the most significant of which is the M&G European Property Fund which contains 11 investments) and around 25% in Asia Pacific (held in six third party funds the most significant of which is the Asia Property Fund, a joint venture between Prudential and LaSalle Investment Management, which contains 5 investments).

ASSET ALLOCATION

ASSET ALLOCATION TABLE

	Optimum Return (PAC Fund)	Optimum Bonus (High RB)	International With-Profits (Sterling)*	International With-Profits (Euro)**	International With-Profits (US Dollar)**	Ringfenced ex Scot Am
UK Equities	37.1	25.7	37.1	N/A	N/A	34.4
North American Equities	3.0	2.1	3.0	5.5	40.0	2.8
European Equities	6.3	4.5	6.3	44.1	6.9	5.6
Japanese Equities	1.7	1.2	1.7	5.2	5.0	1.6
Pacific Market Equities	4.4	3.2	4.4	6.7	7.5	4.0
Other Equities	2.2	1.6	2.2	N/A	N/A	2.4
Property	14.0	10.4	14.0	8.3	10.1	12.8
UK & Euro Fixed Interest	16.8	30.8	16.8	24.6	N/A	21.4
US Fixed Interest	10.1	18.5	10.1	N/A	25.3	12.1
Asia Fixed Interest	0.4	0.7	0.4	N/A	N/A	0.4
Alternative Assets****	3.0	1.3	3.0	2.9	3.0	2.5
Cash	1.0	N/A	1.0	2.7	2.2	N/A
Total	100%	100%	100%	100%	100%	100%

Source: Prudential as at 30 June 2007

* Applicable to With-Profits Sub-Fund (Sterling) and PAC Sterling With-Profits Fund (from 15 July 2005). The assets backing these funds are exactly the same assets that back the Optimum Return (PAC fund).

** Applicable to With-Profits Sub-Fund (Euro) and PAC Euro With-Profits Fund (from 15 July 2005).

*** Applicable to With-Profits Sub-Fund (Dollar) and PAC Dollar With-Profits Fund (from 15 July 2005).

**** Alternative assets include convertible bonds, investments in the Government's private finance initiative (PFI) and hedge funds. The strategy behind these holdings is to invest in assets that we believe can deliver attractive risk-adjusted returns that are expected to have low correlation with the mainstream investment markets.

PAC – Prudential Assurance Company

RB – Reversionary Bonus

PRUDENTIAL

www.pruadviser.co.uk

"Prudential" is a trading name of The Prudential Assurance Company Limited (which is also used by other companies within the Prudential Group). The Prudential Assurance Company Limited is registered in England and Wales. Registered Office at Laurence Pountney Hill, London EC4R 0HH. Registered number 15454. Authorised and regulated by the Financial Services Authority.

The registered office of Prudential International is in Ireland at Montague House, Adelaide Road, Dublin 2.

Prudential International is a marketing name of Prudential International Assurance plc. Registration No. 209956. Telephone number 00 353 1 476 5000.

Prudential International provides life assurance, savings and investment products. If the Company should become unable to meet its liabilities, the Financial Services Compensation Scheme will protect the holder of a policy who is habitually UK resident when their contract starts. This applies to contracts starting after 30 November 2001.

The Financial Services Compensation Scheme will not protect holders of policies issued by the Company before this date.

Authorised in Ireland by the Financial Regulator and regulated by the Financial Services Authority for UK business.