Extended Commentary

BLACKROCK GLOBAL FUNDS (BGF)

BGF World Energy Fund

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Market & Portfolio Performance

The BGF World Energy Fund declined -24.9% in the third quarter, underperforming its benchmark, the MSCI World Energy Index, which returned -20.5%. Brent crude finished the period -5.8% lower at $105.3/barrel. Henry Hub Natural Gas fell -14.5%, ending the quarter at $3.7/mcf (thousand cubic feet).

It was a torrid quarter for global markets. Investors wrestled with a worsening eurozone sovereign debt crisis, weakening economic data, a landmark downgrade by S&P of US debt and nervously digested policy moves (or their conspicuous absence in the case of the eurozone decision makers) to address the precarious environment.

Amidst the deteriorating economic environment, demand data points for oil have disappointed and downside risks have increased. The International Energy Agency (IEA) has moderated its oil demand forecasts by 200 thousand barrels per day (kb/d) for 2011 and 400kb/d for 2012. It is important though to pay due attention to both sides of the fundamental equation: supply as well as demand. The outlook for oil supply growth from non-OPEC remains muted as new sources struggle to offset declines from existing production and moreover, OPEC, the oil cartel controls 43% of the world's production and has vested interests in keeping oil prices supported. The cartel has shown itself able and willing in the past to curb production should crude prices drop to levels which jeopardise their own national fiscal budgets.

The Libyan conflict raged over the period. Rebel fighters took control of key Gaddafi strongholds and the National Transitional Council received international recognition as the interim government of the country. Prior to the conflict, Libya produced 1.6 million barrels per day (mb/d); at its trough production had fallen to 100kb/d and in early October it had reached 350kb/d. A further portion of capacity could be brought onto the market comparatively quickly, but it is our view that it could take up to three years for production to return to pre-conflict levels.

US shale gas assets were the subject of M&A interest. In July, BHP Billiton bid for Petrohawk with a $12bn offer that represented a 65% premium to the previous day's closing price. The deal adds 1 million acres to BHP's oil and gas portfolio and, coming soon after their acquisition of Chesapeake's Fayetteville shale assets, significantly expands the company's energy capabilities. In August, Noble Energy also announced a $3bn joint venture to develop Consol Energy's assets in the Marcellus shale.

In a quarter that saw rotation away from risk assets and bouts of aggressive liquidation, the Fund's underweight to the more defensive, large-cap Integrated oil companies was a source of underperformance. By the same token, some of our higher beta oil services exposure and smaller cap exploration and production names also detracted.

A notable exception was the Fund's holding in Coastal Energy, the US-listed exploration and production company operating offshore Thailand. The company built on the momentum of encouraging appraisal drilling results with news of success from their first exploration well at the Songkhla H field.

The Fund's holding in Enbridge also added relative performance. The pipeline company delivered Q2 results ahead of consensus as well as some exciting newsflow around development and expansion potential: the company has projects that aim to deliver oil for export from Canadian oil sands assets to the West coast as well as from the landlocked Cushing (the major oil delivery point) to the Gulf coast.

Transactions & Portfolio Activity

We remain overweight the Exploration & Production sector with a focus on high conviction, catalyst-rich stocks. Yet this overweight was reduced over the quarter with the balance reinvested in more defensive integrated oil companies, effectively the supermajors.

At the same time, we have been attune to opportunities created by the at times indiscriminate selling and have sought to add to high conviction positions on weakness. We have also increased the cash balance in the Fund to around 5%, giving us the flexibility to take further advantage of liquidity driven market opportunities as they arise.

Market Outlook

Global macroeconomic issues continue to dominate the stock market. In the current climate, demand side risk to the oil price has increased but fundamentals offer encouragement: Japan's forced move to more oil fired power capacity has added incremental barrels to global oil demand, OPEC have shown in the past that they have the appetite and capacity to act in support of prices should they significantly weaken and longer term supply growth is challenged.

Energy equities are trading on depressed valuations on a variety of metrics. On a price to book basis not only is the sector back at 2008 levels but it is also at near parity with the wider market – the customary premium having been eroded. It is important to highlight that supply/demand fundamentals are more supportive now than during the financial crisis and company balance sheets are also much stronger.

We are aware, however, that in the short term fundamentals can take a backseat and the lack of near term economic visibility demands caution. We are equally mindful that such broad-based equity market sell-offs can create opportunities and are monitoring markets carefully.