M&G Episode Allocation Fund

a sub-fund of M&G Investment Funds (4)

Annual Short Report October 2018
For the year ended 31 October 2018

Fund information

The Authorised Corporate Director (ACD) of M&G Investment Funds (4) presents its Annual Short Report for M&G Episode Allocation Fund which contains a review of the fund's investment activities and investment performance during the period. The ACD's Annual Long Report and audited Financial Statements for M&G Investment Funds (4), incorporating all the sub-funds and a Glossary of terms is available free of charge either from our website at www.mandg.co.uk/reports or by calling M&G Customer Relations on 0800 390 390.

ACD

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(Authorised and regulated by the Financial Conduct Authority. M&G Securities Limited is a member of the Investment Association and of the Tax Incentivised Savings Association.)

Important information

On 28 September 2018 the Depositary changed from National Westminster Bank Plc to NatWest Trustee and Depositary Services Limited.

On 31 August 2018, the investment objectives, investment policies and investment approaches of the M&G Episode Allocation Fund were amended.

Investment objective up to 30 August 2018

The fund's objective is to maximise total return (the combination of income and growth of capital) through investment in a diversified range of asset types. Subject to this, the fund aims to grow income in the long term.

Investment policy up to 30 August 2018

The fund manager adopts a flexible approach to the allocation of capital between asset classes in response to changes in economic conditions and the valuation of assets. Central to this approach is the identification of episodes, which are periods of time during which, in the fund manager's view, asset prices become over- or under-stated, relative to objective valuation measures, due to the emotional reaction of investors to events. These episodes can exist over both the short and medium term.

The fund invests in transferable securities, fixed income assets (including, but not limited to, corporate bonds and government and public securities), warrants, money market instruments, deposits, cash and near cash.

Exposure to these assets, and to property, may be gained via collective investment schemes and derivatives (including equity index futures, currency forwards, interest rate swaps and other liquid derivatives). The fund will invest no more than 60% of the portfolio in equities. Derivatives may also be used for efficient portfolio management purposes.

Investment approach up to 30 August 2018

The fund will typically invest 20-60% of its assets in company shares, 30-75% in fixed income securities (including cash) and up to 20% in other assets, which can include indirect exposure to property and convertibles (fixed income investments that have the right to be converted into a predetermined number of company shares).

The fund managers will actively manage the fund's foreign currency exposure to seek to enhance returns, with a minimum of 30% of the fund exposed to sterling and a minimum of 60% in developed market currencies. The fund's investment strategy may involve the use of financial instruments to take short positions, that is, positions that profit from a fall in the price of an asset.

Investment objective from 31 August 2018

The fund aims to deliver a total return (the combination of capital growth and income) of at least 5% per annum above the 3-month GBP LIBOR rate, before any charges are taken, over any five-year period.

There is no guarantee that the fund will achieve a positive return over five years, or any other, period, and investors may not get back the original amount they invested.

Investment policy from 31 August 2018

The fund is a multi-asset fund that invests across a range of asset classes, including equities, fixed income securities, convertibles, cash and near cash. Exposure to these assets may be gained either directly or indirectly via collective investment schemes or derivatives. The fund may also invest indirectly via collective investment schemes or derivatives in other asset classes such as property and gold.

The currency exposure of the fund will be actively managed, seeking to enhance returns, with a minimum of 30% of the fund exposed to sterling and a minimum of 60% in developed market currencies (including sterling).

Derivatives may be used for investment purposes, efficient portfolio management and hedging.

Investment approach from 31 August 2018

The fund managers have a flexible top-down approach to the allocation of capital between different types of assets in response to changes in economic conditions and asset values. This approach combines in-depth research to work out the value of assets over the medium to long term, with analysis of market reactions to events to identify investment opportunities. In particular, the managers seek to respond when asset prices move away from a reasonable sense of ‘fair’ long-term value due to market reactions to events.

The fund seeks to manage risk by investing globally across multiple asset classes, sectors, currencies and countries. The fund will typically invest 20- 60% of its assets in equities and convertibles, 30-75% in fixed income securities or cash, and up to 20% in other assets. These allocations reflect the net exposure of the portfolio.

The fund will typically take investment positions at index or sector level, but it may also take positions in individual shares or bonds. The fund’s investment strategy may involve the use of derivatives to take long or short positions.

Fund information

Risk profile

The fund invests globally in a broad range of assets, including company shares (equities), fixed income securities (bonds), currencies and other assets such as property shares and convertible bonds. The fund is, therefore, subject to the price volatility of global financial and currency markets. Exposure to the different asset classes may be gained through the use of derivatives.

In association with the use of derivatives, including those instruments not traded through an exchange, collateral is deposited, in order to mitigate the risk that a counterparty may default on its obligations or become insolvent.

The fund adopts a flexible approach to the allocation of capital between asset classes in response to changes in economic conditions and the valuation of assets, and the managers will seek to maximise portfolio diversity wherever possible. However, in cases where the managers believe that the opportunities are limited to a few areas, there may be a higher-than-usual concentration of asset or market exposure. Such strategies may result in higher volatility of the fund's short-term performance.

The blend of assets held in the fund is regularly adjusted depending on where the managers see the most value and to manage risks, including liquidity, credit, currency and market risks. The fund's risks are measured and managed as an integral part of the investment process.

Please note that the risk management policies are set out in full in the financial statements and notes sections of the Annual Long Report and audited Financial Statements of M&G Investment Funds (4).

The following table shows the risk number associated with the fund and is based on Sterling Class 'A' shares.

Low risk — High risk

Typically lower rewards — Typically higher rewards

1	2	3	**4**	5	6	7

The above number:

- is based on the rate at which the value of the fund has moved up and down in the past and is based on historical data so may not be a reliable indicator of the future risk profile of the fund.
- is not guaranteed and may change over time and the lowest risk number does not mean risk free.
- has not changed during this period.

Investment review

As at 1 November 2018, for the year ended 31 October 2018

Performance against objective

Between 1 November 2017 (the start of the review period) and 1 November 2018, the M&G Episode Allocation Fund produced a negative total return (the combination of income and growth of capital), which was below 3-month LIBOR + 5.0% across all share classes. The fund's returns were also behind those of its peer group, the IA Mixed Investment 20-60% Sector.

The fund's objective is to achieve a total return of at least 5% per annum above the 3-month GBP LIBOR rate, before any charges are taken, over any five-year period. LIBOR is the rate at which banks borrow money from each other. Over five years, the fund has met its objective; the annualised five-year return before any charges was 6.1% versus three-month LIBOR + 5.0% of 5.6%.*

* For the performance of each share class, please refer to the 'Long-term performance by share class' table in the 'Fund performance' section of the Annual Long Report and audited Financial Statements for M&G Investment Funds (4).

To give an indication of the performance of the fund, the following table shows the compound rate of return, per annum, over the period for Sterling Class 'A' (Accumulation) shares and Sterling Class 'I' (Accumulation) shares. Calculated on a price to price basis with income reinvested.

Long-term performance

	One year 01.11.17 % [a]	Three years 02.11.15 % p.a.	Five years 01.11.13 % p.a.	Since launch % p.a.
Sterling [b]				
Class 'A'	-5.8	+4.7	+4.4	+5.1 [c]
Class 'I'	-5.2	+5.3	+5.0	+6.4 [d]

[a] Absolute basis.

[b] Price to price with income reinvested.

[c] 16 February 2007, the launch date of the fund.

[d] 3 August 2012, the launch date of the share class.

Please note past performance is not a guide to future performance and the value of investments, and the income from them, will fluctuate. This will cause the fund price to fall as well as rise and you may not get back the original amount you invested.

Investment performance

The year under review was dominated by investor concerns about trade wars between the US and China, worries on the direction of the global economy – especially whether US economic growth had peaked – and general pessimism towards countries grappling with their own special problems, such as Turkey, Italy, Argentina and Brazil.

There were periods when investor appetite improved, and our basket of diversified global equities (company shares) did well as a result. But the overall pattern over the 12 months under review was usually a sharp pullback in risk-taking (and flight to so-called 'safe-haven' assets, which are generally assets that investors believe would protect them from the impact of a big fall in asset prices) immediately following a positive month in the markets. September and October were good examples of this. In fact, October was a notably bleak month for virtually all assets, including US stocks and, untypically, the US technology sector (Amazon, Google parent Alphabet and the like).

This aversion to risk assets and pessimistic view of the path of the global economy – which we think is without justification given the underlying facts – weighed on fund performance in the period. On the other hand, it did lead to some attractive valuations in the likes of US equities, China equities and, selectively, in risk assets out of undervalued Italy and Turkey.

North American equities, especially US financial company shares, added to returns in the period, as the S&P 500 Index continued its steady climb, supported by strong company earnings and a rosy outlook for the domestic economy. However, holdings in European stockmarkets, notably German, Spanish, and Italian company shares, detracted as these assets suffered from being seen as having strong links to struggling peripheral European countries like Turkey. Exposure to Asian equity markets also weighed on performance in the period. For example, South Korean equities fell on trade threats for its key export industries. Japanese stocks wobbled for similar reasons, although we continue to see strong earnings from its domestic market.

Within bonds, contributions to performance were mixed, particularly within emerging market issuers. (Bonds are loans that are extended by an investor to an issuer – such as a company or government – usually in exchange for regular interest payments. Bonds issued by companies are referred to as 'corporate bonds', while those issued by governments are called 'government bonds'.) Bonds issued by Mexico and Brazil added to performance in the period, investors seeing their respective general election outcomes as market-friendly. Exposure to South African government bonds detracted, while peripheral European government bonds broadly weighed on performance. These markets generally suffered from various bouts of risk aversion in the period, as investors grew concerned on fiscal and monetary policy uncertainty.

Holdings in corporate bonds issued by UK mining companies provided a small source of positive returns, while the fund's exposure to convertible bonds detracted. A holding in the M&G Property Portfolio, a UK commercial property fund, boosted returns as investors generally shrugged off Brexit fears and warmed to a better outlook for the market in 2018.

Investment activities

While we chose not to make any changes to our portfolio in the final months of 2017, during the following months (to 1 November 2018) we increased risk by adding selectively across global equities – mainly in Japanese and Chinese equities – and emerging market government bonds on the basis that these investments were attractively priced and provided the potential for strong returns in the coming months.

Within equities, we added to our exposure to European banks (Italian and Spanish) after they sold off significantly in the first half of the year. We believed this much-improved cyclical sector was benefiting from a stronger economic outlook for the region, although this had not been priced into valuations.

In September, we sold around 2.5% of the fund's net asset value invested in the S&P 500 Index, bringing the exposure down to 1%, and redirected this to China equities, which we view as cheap on a valuation basis versus US equities.

Within bonds, the forming of a populist government in Italy in late spring caused a significant repricing of Italian debt compared to other eurozone governments. The yield on the 10-year Italian government bonds rose from 1.7% in early May to over 3% at the end of June. As volatility continued in June, we decided to open a 5% position in the 10-year bond, funded out of cash. (Bond yield refers to the interest received from a fixed income security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.)

In the same period we added a 1% position in Turkish 10-year government bonds (US dollar-denominated) as the price of these bonds fell materially throughout the period. While Turkish risk assets have been hit severely this year, we think the US dollar-denominated bond offered the opportunity to add country-level exposure, but with an asset that should have different portfolio characteristics as we extend our time horizons.

Investment review

In June we added 1.5% to a 1.5% position in 20-year South African government bonds that we had started in January, bringing the total to 3%. South African bonds have been caught up in contagion across emerging markets. While economic growth has slowed modestly in South Africa, the weakness in its bonds and the rand has little to do with the fundamentals, in our view.

Outlook

The fund is positioned pro-risk in what we view as a pro-growth world – although we acknowledge that recent growth forecasts have edged lower on trade tariff concerns and worries over a slowing Chinese economy.

We also have more conviction that some of the fund's risk exposures – across Turkey, Italy and Argentina, for example – are starting to behave independently of each other. In the summer, the opposite was largely true; Italian banks lost 20% of their value on investors' belief that the much-maligned sector's fortunes were strongly linked to that of the Turkish economy.

There are still concerns on the valuation of developed government bonds, and we continue to view the risk properties of the likes of UK and German government bonds as unfavourable for multi-asset portfolios. The exception to this is US Treasuries, which are close to fair value and, for instance, yielding around 2.8% on two-year bonds. In our view, these government bonds continue to represent meaningful diversification in an environment of economic expansion and persistently low inflation, and we may look to add to them in the coming quarters.

As volatility has picked up this year, valuations have improved in many equity markets, and we believe this bodes well for the fund's investment approach. With all the noise, we believe it is important to remain focused on areas such as underlying earnings expectations, which continue to move higher. This is encouraging at a time when inflation is remarkable in its stability.

Tony Finding & Juan Nevado
Co-fund managers

Employees of M&G Limited which is an associate of M&G Securities Limited.

Please note that the views expressed in this Report should not be taken as a recommendation or advice on how the fund or any holding mentioned in the Report is likely to perform. If you wish to obtain financial advice as to whether an investment is suitable for your needs, you should consult a Financial Adviser.

Classification spread of investments

The table below shows the percentage holding per sector.

	% of fund as at 2018	2017 [a]
EQUITIES		
United Kingdom		
UK equities	0.61	0.42
Europe		
European equities	2.18	0.44
North America		
North American equities	4.64	5.53
Global		
Global equity funds [b]	5.26	5.62
Other		
Other equities	6.78	5.74
FIXED INCOME		
United Kingdom		
UK Government bonds	11.33	0.00
UK below investment grade corporate bonds	0.73	0.85
Europe		
Europe Government bonds	4.76	1.90
North America		
North America Government bonds	37.96	16.65
North America investment grade corporate bonds	0.74	0.85
North America below investment grade corporate bonds	0.71	0.85
Asia Pacific (ex Japan)		
Asia Pacific Government bonds	1.00	0.00
Global		
Global fixed income funds [b]	4.68	5.30
Other		
Other Government bonds	4.56	2.52
Other investment grade corporate bonds	1.17	2.00
Other interest rate futures	(0.98)	1.45
PROPERTY		
United Kingdom [b]	6.65	5.38
CURRENCY		
Forward currency contracts	0.51	0.81
CASH EQUIVALENTS		
'AAA' rated money market funds [c]	1.40	33.89

[a] The portfolio has been reclassified to more appropriately reflect how the fund is managed. 2017 comparatives have been restated to reflect this.

[b] All holdings in M&G collective investment schemes are in Sterling Class 'A' (Income) shares unless otherwise stated.

[c] Uncommitted surplus cash is placed into 'AAA' rated money market funds with the aim of reducing counterparty risk.

Please note past performance is not a guide to future performance and the value of investments, and the income from them, will fluctuate. This will cause the fund price to fall as well as rise and you may not get back the original amount you invested.

The following chart and tables show the performance for two of the fund's share classes – Sterling Class 'A' (Accumulation) shares and Sterling Class 'I' (Accumulation) shares.

We show performance for these two share classes because:

- The performance of the Sterling Class 'A' (Accumulation) share is what most individuals investing directly with M&G have received. It has the highest ongoing charge of all the share classes. Performance is shown after deduction of this charge. All investors in the fund therefore received this performance or better.
- The performance of the Sterling Class 'I' (Accumulation) share is the most appropriate to compare with the average performance of the fund's comparative sector. It is the share class used by the Investment Association in the calculation of the comparative sector's average performance. This share class is available for direct investment with M&G subject to minimum investment criteria, or via third parties who may charge additional fees. The performance shown takes the deduction of the ongoing charge for this share class into account but it does not take account of charges applied by any other party through which you may have invested.

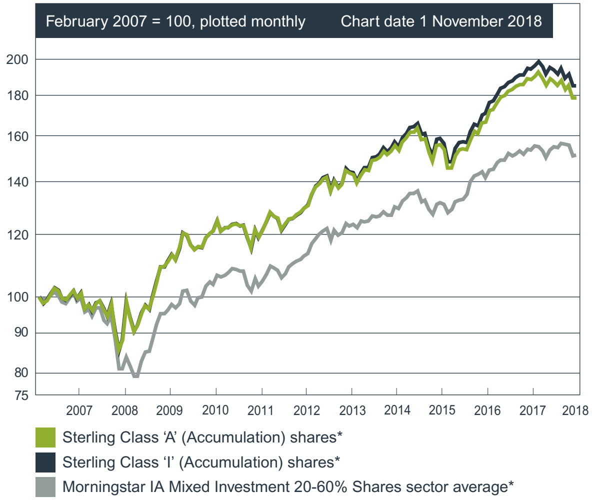
The fund is available for investment in different share classes, each with varying levels of charges and minimum investments; please refer to the Prospectus for M&G Investment Funds (4), which is available free of charge either from our website at www.mandg.co.uk/prospectuses or by calling M&G Customer Relations. For the specific performance tables of all share classes, please refer to the Annual Long Report and audited Financial Statements for M&G Investment Funds (4), which is available free of charge either from our website at www.mandg.co.uk/reports or by calling M&G Customer Relations.

Fund level performance

Fund net asset value			
as at 31 October	2018 £'000	2017 £'000	2016 £'000
Fund net asset value (NAV)	609,767	550,233	350,964

Performance since launch

To give an indication of how the fund has performed since launch, the chart below shows total return of Sterling Class 'A' (Accumulation) shares and Sterling Class 'I' (Accumulation) shares.



* Income reinvested

Source: Morningstar, Inc. and M&G

The fund's Sterling Class 'I' (Accumulation) shares were launched on 3 August 2012. Performance data shown prior to this date is that of the fund's Sterling Class 'A' (Accumulation) shares.

Financial highlights

Fund performance

To give an indication of how the fund has performed during the period the tables below show the performance of Sterling Class 'A' (Accumulation) shares and Sterling Class 'I' (Accumulation) shares.

All 'Performance and charges' percentages represent an annual rate except for the 'Return after operating charges' which is calculated as a percentage of the opening net asset value per share (NAV). 'Dilution adjustments' are only in respect of direct portfolio transaction costs.

Historic yields for the current year are calculated as at 9 November 2018.

Sterling Class 'A' Accumulation share performance

The share class was launched on 16 February 2007.

for the year to 31 October Change in NAV per share	2018 UK p	2017 UK p	2016 UK p
Opening NAV	188.23	166.10	154.89
Return before operating charges and after direct portfolio transaction costs	(7.56)	25.10	13.68
Operating charges	(3.02)	(2.97)	(2.47)
Return after operating charges	(10.58)	22.13	11.21
Distributions	(1.52)	(1.12)	(3.75)
Retained distributions	1.52	1.12	3.75
Closing NAV	177.65	188.23	166.10
Direct portfolio transaction costs	**UK p**	**UK p**	**UK p**
Costs before dilution adjustments	0.04	0.01	0.01
Dilution adjustments [a]	0.00	(0.01)	0.00
Total direct portfolio transaction costs	0.04	0.00	0.01
Performance and charges	**%**	**%**	**%**
Direct portfolio transaction costs [b]	0.02	0.01	0.01
Operating charges	1.61	1.64	1.60
Return after operating charges	-5.62	+13.32	+7.24
Historic yield	0.85	0.60	2.29
Effect on yield of charges offset against capital	0.00	0.00	1.35
Other information			
Closing NAV (£'000)	152,423	129,924	62,000
Closing NAV percentage of total fund NAV (%)	25.00	23.61	17.66
Number of shares	85,800,043	69,023,967	37,325,965
Highest share price (UK p)	193.87	188.99	166.95
Lowest share price (UK p)	176.14	161.91	136.92

Sterling Class 'I' Accumulation share performance

The share class was launched on 3 August 2012.

for the year to 31 October Change in NAV per share	2018 UK p	2017 UK p	2016 UK p
Opening NAV	1,540.63	1,351.36	1,252.43
Return before operating charges and after direct portfolio transaction costs	(64.55)	202.56	109.48
Operating charges	(13.25)	(13.29)	(10.55)
Return after operating charges	(77.80)	189.27	98.93
Distributions	(21.64)	(17.99)	(28.43)
Retained distributions	21.64	17.99	28.43
Closing NAV	1,462.83	1,540.63	1,351.36
Direct portfolio transaction costs	**UK p**	**UK p**	**UK p**
Costs before dilution adjustments	0.35	0.07	0.08
Dilution adjustments [a]	(0.03)	(0.05)	(0.02)
Total direct portfolio transaction costs	0.32	0.02	0.06
Performance and charges	**%**	**%**	**%**
Direct portfolio transaction costs [b]	0.02	0.01	0.01
Operating charges	0.86	0.89	0.84
Return after operating charges	-5.05	+14.01	+7.90
Historic yield	1.47	1.17	2.13
Effect on yield of charges offset against capital	0.00	0.00	0.60
Other information			
Closing NAV (£'000)	340,028	287,826	198,807
Closing NAV percentage of total fund NAV (%)	55.76	52.31	56.65
Number of shares	23,244,607	18,682,329	14,711,649
Highest share price (UK p)	1,589.05	1,546.81	1,358.11
Lowest share price (UK p)	1,450.31	1,317.31	1,109.14

[a] In respect of direct portfolio transaction costs.

[b] As a percentage of average net asset value.

We explain below the payments made to meet the ongoing costs of investing and managing the fund, comprising operating charges and portfolio transaction costs.

Operating charges

Operating charges include payments made to M&G and to providers independent of M&G:

- **Investment management:** Charge paid to M&G for investment management of the fund (also known as Annual Management Charge).
- **Administration:** Charge paid to M&G for administration services in addition to investment management – any surplus from this charge will be retained by M&G.
- **Oversight and other independent services:** Charges paid to providers independent of M&G for services which include depositary, custody and audit.
- **Ongoing charges from underlying funds:** Ongoing charges on holdings in underlying funds that are not rebated.

Operating charges do not include portfolio transaction costs or any entry and exit charges (also known as initial and redemption charges). The charging structures of share classes may differ, and therefore the operating charges may differ.

Operating charges are the same as the ongoing charges shown in the Key Investor Information Document, other than where an estimate has been used for the ongoing charge because a material change has made the operating charges unreliable as an estimate of future charges.

For this fund there is no difference between operating charges and ongoing charges figures, unless disclosed under the specific share class performance table.

Portfolio transaction costs

Portfolio transaction costs are incurred by funds when buying and selling investments. These costs vary depending on the types of investment, their market capitalisation, country of exchange and method of execution. They are made up of direct and indirect portfolio transaction costs:

- **Direct portfolio transaction costs:** Broker execution commission and taxes.
- **Indirect portfolio transaction costs:** 'Dealing spread' – the difference between the buying and selling prices of the fund's investments; some types of investment, such as fixed interest securities, have no direct transaction costs and only the dealing spread is paid.

Investments are bought or sold by a fund when changes are made to the investment portfolio and in response to net flows of money into or out of the fund from investors buying and selling shares in the fund.

To protect existing investors, portfolio transaction costs incurred as a result of investors buying and selling shares in the fund are recovered from those investors through a 'dilution adjustment' to the price they pay or receive. The table below shows direct portfolio transaction costs paid by the fund before and after that part of the dilution adjustment relating to direct portfolio transaction costs. To give an indication of the indirect portfolio dealing costs the table also shows the average portfolio dealing spread.

Further information on this process is in the Prospectus, which is available free of charge on request either from our website at www.mandg.co.uk/prospectuses or by calling M&G Customer Relations.

Portfolio transaction costs

for the year to 31 October Direct portfolio transaction costs [b]	2018 %	2017 %	2016 %	Average [a] %
Broker commission	0.01	0.01	0.01	0.01
Taxes	0.01	0.00	0.00	0.00
Costs before dilution adjustments	0.02	0.01	0.01	0.01
Dilution adjustments [c]	0.00	0.00	0.00	0.00
Total direct portfolio transaction costs	0.02	0.01	0.01	0.01
as at 31 October Indirect portfolio transaction costs	**2018 %**	**2017 %**	**2016 %**	**Average [a] %**
Average portfolio dealing spread	0.50	0.43	0.52	0.48

[a] Average of first three columns.

[b] As a percentage of average net asset value.

[c] In respect of direct portfolio transaction costs. Please see the section above this table for an explanation of dilution adjustments.

Notes

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