



M&G Gilt & Fixed Interest Income Fund

a sub-fund of M&G Investment Funds (2)

Annual Short Report May 2019
For the year ended 31 May 2019

The Authorised Corporate Director (ACD) of M&G Investment Funds (2) presents its Annual Short Report for M&G Gilt & Fixed Interest Income 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 (2), 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 & Depositary Services Limited.

As per shareholder letter 17 June 2019, we are making changes to the way we charge for M&G funds based in the UK, starting on Thursday 1 August 2019. The annual charge should be simpler to understand and easier to compare with other fund charges. We are combining all the charges that make up the current ongoing charge figure (OCF) into a single annual charge. Only exceptional items such as unforeseen legal and tax expenses, also known as extraordinary expenses, will be excluded from the annual charge. To find out the new annual charge and the OCF on the KIID for the share class(es) you are invested in, visit our website www.mandg.co.uk.

Investment objective

The fund aims to provide income and capital growth.

Investment policy

At least 70% of the fund is invested in short, medium or long-dated gilts according to the fund manager's view at any given moment of the likely course of interest rates and trend of the gilt market. The fund's exposure to gilts may be gained through the use of derivatives. Derivatives may also be used for efficient portfolio management. The Fund may also invest in collective investment schemes, other transferable securities, other debt instruments, cash, near cash, other money market securities, warrants and other derivative instruments.

Investment approach

The fund manager's investment approach is driven primarily by macroeconomic factors such as views on interest rates, inflation and economic growth and tends not to be influenced by short-term changes in the economic or market environment.

Risk profile

The fund invests in fixed income securities, or bonds, issued by the UK government. It is, therefore, subject to the price volatility of the UK government bond market. It is also influenced by developments in the broader global government bond market. UK government bonds are highly liquid securities, meaning they are normally traded with relative ease.

The fund's exposure to debt securities 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.

Portfolio diversification is key in managing liquidity and default risks as well as reducing market risk. 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 (2).

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



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.

As at 3 June 2019, for the year ended 31 May 2019

Performance against objective

Between 1 June 2018 (the start of the review period) and 3 June 2019, the M&G Gilt & Fixed Interest Income Fund's Sterling Class 'A' and 'I' shares delivered a total return (the combination of income and growth of capital) of 4.2% and 4.4%, respectively. This was behind the average return from the fund's peer group, the IA UK Gilts sector, which was 5.0% over the same period.

Over this reporting period, the fund has met its objective of providing income and capital growth. The fund has also met its objective over three and five years and since launch.*

* 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 (2).

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 01.06.18 % [a]	Three years 03.06.16 % p.a.	Five years 03.06.14 % p.a.	Since launch % p.a.
Sterling [b]				
Class 'A'	+4.2	+2.8	+4.7	+6.7 [c]
Class 'I'	+4.4	+3.0	+5.0	+3.2 [d]

[a] Absolute basis.

[b] Price to price with income reinvested.

[c] 9 December 1980, the end of the initial offer period of the predecessor unit trust.

[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

UK government bonds (also known as gilts) were favoured by investors during periods of increased uncertainty with regard to the country's Brexit discussions, in particular fears of a disorderly or 'hard' Brexit, as investors turned to the perceived safety of government bonds. Gilts were also supported at times of heightened international trade tensions. (Bonds are loans in the form of a security, usually issued by a government (government bonds) or a company (corporate bonds), which normally pay a fixed rate of interest over a given period, at the end of which the initial amount borrowed is repaid.)

A variety of factors weighed on investor sentiment throughout the second half of 2018, including concerns about the negative impact of rising US interest rates, escalating trade war tensions between the US and China, and political turmoil in Europe and several emerging markets. The mood then changed in early 2019, as investors took comfort from statements by the US Federal Reserve that it would moderate its strategy of raising interest rates, due to the global economic slowdown, lower oil prices and muted domestic inflation. However, a deterioration in US-China trade developments as well as events in UK domestic politics led to a pronounced 'risk-off' mood at the end of the period under review, which led to strong returns for gilts in May 2019.

In terms of political developments, Brexit talks continued to dominate the headlines in the UK over the period under review. Prime Minister Theresa May secured a withdrawal treaty with the European Union (EU), but members of parliament have rejected the treaty three times. The original date for Brexit came and went and a new deadline of 31 October 2019 has been agreed. However, the UK was compelled to hold elections to the European Parliament in May. Theresa May resigned, paving the way for a new prime minister and potentially increasing the possibility of a 'no deal'.

The UK economy has held up fairly well, with interest rates relatively low and record high employment levels, while UK companies' balance sheets are well capitalised. In general terms, domestic growth appears to have been hampered as firms delay investment decisions due to Brexit-related uncertainty. However, a surge in business activity in spring 2019 appears to reflect companies' preparation for potential Brexit-related difficulties.

The Bank of England raised interest rates by a quarter of a percentage point in August 2018, taking them to 0.75%. However, further increases are likely to be closely linked to Brexit developments and prospects for

the domestic economy. In the current uncertain environment, changes to interest rates are likely to be limited and gradual. UK inflation, as measured by the Consumer Prices Index, stood at 2.0% in May, compared with a five-year high of 3.1% in November 2017.

In the US, the Federal Reserve (Fed) increased interest rates three times during the review period – in June, September and December 2018 – each time by a quarter of a percentage point. Meanwhile, after some weakness in early 2019, the news from Europe has been more positive recently, with stronger-than-expected economic growth, although it remains lacklustre.

Overall, UK government bonds rose in value over the 12 months under review, buoyed by investor demand for safe-haven assets amid the economic and geopolitical uncertainties. Gilts with the longest time until repayment (+15 years) delivered the strongest gains (6%), while returns from issues maturing in less than five years were comparatively modest (+1.3%).

Investment activities

The fund's performance is affected by its 'duration', which refers to the portfolio's sensitivity to changes in interest rates.

For some time, we have positioned the portfolio to be less sensitive to the possibility of rising interest rates and we broadly maintained this position over the 12 months under review. However, we may look to increase duration in the coming months as we are unconvinced about the market's expectation of cuts in US interest rates in the rest of this year. Furthermore, the UK economy continues to advance, albeit modestly, despite Brexit-related uncertainty, making cuts in the domestic interest rate less likely.

Government bonds with a short time until repayment are often less sensitive to interest rate movements than bonds with a longer maturity date. We generally favour gilts maturing in 7-10 years, while we also favour gilts maturing in 25-30 years. We also see value in gilts maturing in 35-40 years.

We continued to find 'relative value' opportunities within the gilt market, which involved buying the gilts that seemed to offer the most attractive value. For example, we sold some positions in gilts maturing in 30 years, instead buying some maturing in 40 years, which appeared more attractively valued. In other activities, we switched out of some US dollar-denominated holdings – bonds from KfW and European Investment Bank – after they had performed better than their sterling equivalents.

Outlook

At the time of writing, the outlook remains relatively uncertain due to a lack of clarity about Brexit, while global economic growth appears to be easing and international trade wars continue. Despite the absence of any meaningful progress regarding Brexit, the UK economy is still growing, albeit at a modest pace with a lack of business investment and slower economic activity among the UK's main trading partners acting as a drag. Recent data suggest that UK manufacturing and construction declined in May 2019, while growth continues in the important services sector, but remains modest.

Following Theresa May's resignation, a multi-candidate leadership contest is expected to see a new prime minister in place by the end of July, with the outcome likely to affect the course of the Brexit negotiations. This in turn will have a significant influence on prospects for the UK economic and political backdrop. Leaving the EU without a deal would probably weaken sterling, which could lead to higher import costs and potentially higher inflation. In contrast, a more orderly exit may prove supportive to sterling.

Gilts tend to be favoured by investors during volatile periods due to their perceived status as a lower risk asset class. We therefore feel that UK government bonds should prove attractive to investors in the current uncertain climate.

Matthew Russell

Fund manager

An employee 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 of investments

The table below shows the percentage holding per sector.

as at 31 May	% of fund	
	2019	2018
FIXED INCOME		
Debt securities		
'AAA' credit rated bonds	10.33	6.78
'AA' credit rated bonds	86.32	90.40
'A' credit rated bonds	0.89	0.83
Bonds with no credit rating	1.08	0.74
Debt derivatives		
Interest rate futures	(0.11)	(0.02)
CASH EQUIVALENTS		
'AAA' rated money market funds ^[a]	0.14	0.13

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

Financial highlights

Fund performance

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 sterling share classes. Performance is shown after deduction of this charge. All UK 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.

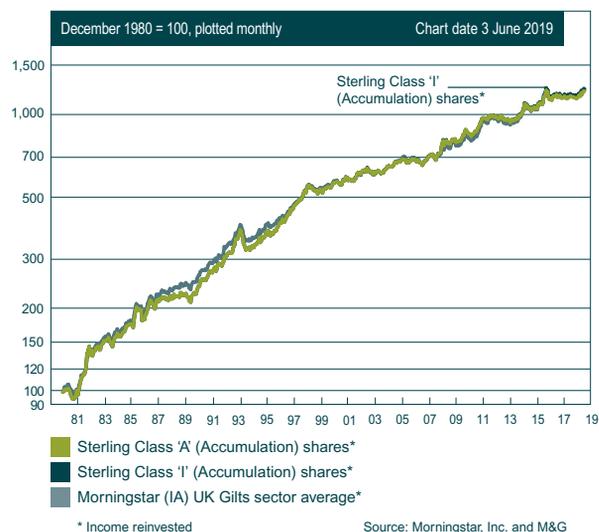
The fund is available for investment in different share classes, each with varying levels of charges and minimum investments; please refer to the Prospectus for M&G Investment Funds (2), which is available free of charge either from our website at www.mandg.co.uk/prospectuses or by calling M&G Customer 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 (2), 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			
	2019	2018	2017
as at 31 May	£'000	£'000	£'000
Fund net asset value (NAV)	559,869	596,796	648,310

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.



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.

Sterling Class 'A' Accumulation share performance

The share class was launched on 9 December 1980.

for the year to 31 May Change in NAV per share	2019 UK p	2018 UK p	2017 UK p
Opening NAV	556.19	562.03	524.72
Return before operating charges and after direct portfolio transaction costs	26.13	(0.83)	42.64
Operating charges	(5.05)	(5.01)	(5.04)
Return after operating charges	21.08	(5.84)	37.60
Distributions	(2.65)	(1.75)	(2.62)
Retained distributions	2.65	1.75	2.33
Closing NAV	577.27	556.19	562.03

Direct portfolio transaction costs	UK p	UK p	UK p
Costs before dilution adjustments	0.00	0.00	0.00
Dilution adjustments ^[a]	0.00	0.00	0.00
Total direct portfolio transaction costs	0.00	0.00	0.00

Performance and charges	%	%	%
Direct portfolio transaction costs ^[b]	0.00	0.00	0.00
Operating charges	0.91	0.91	0.91
Return after operating charges	+3.79	-1.04	+7.17
Distribution yield	0.43	0.40	0.27
Effect on yield of charges offset against capital	0.00	0.00	0.00

Other information

Closing NAV (£'000)	335,149	332,613	351,649
Closing NAV percentage of total fund NAV (%)	59.86	55.74	54.24
Number of shares	58,057,391	59,802,398	62,567,997
Highest share price (UK p)	577.27	564.05	585.09
Lowest share price (UK p)	535.78	535.55	528.62

Sterling Class 'I' Accumulation share performance

The share class was launched on 3 August 2012.

for the year to 31 May Change in NAV per share	2019 UK p	2018 UK p	2017 UK p
Opening NAV	1,187.96	1,197.44	1,115.43
Return before operating charges and after direct portfolio transaction costs	55.96	(1.73)	90.68
Operating charges	(7.84)	(7.75)	(7.77)
Return after operating charges	48.12	(9.48)	82.91
Distributions	(8.63)	(6.67)	(8.51)
Retained distributions	8.63	6.67	7.61
Closing NAV	1,236.08	1,187.96	1,197.44

Direct portfolio transaction costs	UK p	UK p	UK p
Costs before dilution adjustments	0.01	0.00	0.00
Dilution adjustments ^[a]	0.00	0.00	0.00
Total direct portfolio transaction costs	0.01	0.00	0.00

Performance and charges	%	%	%
Direct portfolio transaction costs ^[b]	0.00	0.00	0.00
Operating charges	0.66	0.66	0.66
Return after operating charges	+4.05	-0.79	+7.43
Distribution yield	0.68	0.65	0.51
Effect on yield of charges offset against capital	0.00	0.00	0.00

Other information

Closing NAV (£'000)	153,439	154,575	170,815
Closing NAV percentage of total fund NAV (%)	27.41	25.90	26.35
Number of shares	12,413,361	13,011,801	14,265,003
Highest share price (UK p)	1,236.07	1,202.56	1,244.42
Lowest share price (UK p)	1,145.41	1,143.07	1,123.71

^[a] In respect of direct portfolio transaction costs.

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

Financial highlights

Operating charges and portfolio transaction costs

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. As the fund invests mainly in fixed interest securities, the direct transaction costs paid on other investments are too small to be reflected in the table below. To give an indication of the indirect portfolio dealing costs the table below 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				
as at 31 May	2019	2018	2017	Average ^[a]
Indirect portfolio transaction costs	%	%	%	%
Average portfolio dealing spread	0.07	0.08	0.07	0.07

[a] Average of first three columns.

Contact



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* For security purposes and to improve the quality of our service, we may record and monitor telephone calls. You will require your M&G client reference. Failure to provide this will affect your ability to transact with us.

** Please remember to quote your name and M&G client reference and sign any written communication to M&G. Failure to provide this may affect your ability to transact with us.

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