M&G Optimal Income Fund

Annual Short Report September 2018
For the year ended 30 September 2018

Fund information

The Authorised Corporate Director (ACD) of M&G Optimal Income Fund presents its Annual Short Report 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 Optimal Income Fund, incorporating 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

As a result of the Extraordinary General Meetings of Shareholders held on 4 October 2018, the non-sterling share classes of the M&G Optimal Income Fund will be merged into corresponding share classes of the M&G (Lux) Optimal Income Fund, a sub-fund of M&G (Lux) Investment Funds 1.

For further details on the mergers and the date at which these will occur, please refer to:
https://www.mandg.com/brexitmergerdocumentation.

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

Investment objective

The fund aims to provide a total return (the combination of income and growth of capital) to investors based on exposure to optimal income streams in investment markets.

Investment policy

The fund aims to provide a total return (the combination of income and growth of capital) to investors through strategic asset allocation and specific stock selection. The fund will be at least 50% invested in debt instruments, but may also invest in other assets including collective investment schemes, money market instruments, cash, near cash, deposits, equities and derivatives. Derivative instruments may be used for both investment purposes and efficient portfolio management.

Investment approach

The M&G Optimal Income Fund is a flexible bond fund, allowing investment across a broad range of fixed income assets according to where the fund manager identifies value. The investment approach begins with a top-down assessment of the macroeconomic environment, including the likely path of growth, inflation and interest rates. The results of this analysis help inform the fund's duration positioning and its allocation to the various bond asset classes. Individual credit selection is carried out in conjunction with M&G's in-house team of credit specialists, which provides bottom-up analysis of the corporate bond markets to complement the fund manager's views.

There are no restrictions on the amount of government bonds, investment grade bonds or high yield bonds that can be held within the portfolio. The fund may also invest in other assets, including cash, equities and derivatives. Derivative instruments may be used for both investment purposes and efficient portfolio management.

Fund information

Risk profile

The fund is a flexible bond fund which invests in a range of fixed income securities. In addition, up to 20% of the portfolio may be invested in company shares when the fund manager believes they offer better value than bonds. The fund is therefore subject to the price volatility of global bond and stockmarkets as well as the performance of individual companies. The fund is also subject to fluctuations in currency exchange rates.

There are no restrictions on the amount of government bonds, investment grade bonds or high yield bonds that can be held within the portfolio. While government and investment grade bonds are generally highly liquid assets that are normally traded with relative ease, high yield corporate bonds are higher risk assets that could potentially experience a degree of illiquidity in times of market distress. The fund's exposure to company shares is typically through large companies, where the shares are normally traded with relative ease.

The fund's exposure to fixed income 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 section of the Annual Long Report and audited Financial Statements for M&G Optimal Income Fund.

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 October 2018, for the year ended 30 September 2018

Performance against objective

Between 2 October 2017 (the start of the review period) and 1 October 2018, the M&G Optimal Income Fund delivered either a positive or negative total return (the combination of income and growth of capital) depending on its share class*.

Most of the fund's holdings are split between high quality, or investment grade, corporate bonds and high yielding corporate bonds, with a smaller allocation to government bonds, as these typically provide liquidity and stability in uncertain markets.

Bonds are loans that are extended by an investor to an issuing entity – such as a company or government – 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'. Investment grade corporate bonds refer to fixed income securities issued by a company with a medium or high credit rating from a recognised credit rating agency. They are considered to be at lower risk of non-repayment than those issued by companies with lower credit ratings (known as high yield bonds). The performance of investment grade corporate bond markets can be influenced by the performance of government bonds.

* 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 Optimal Income Fund.

Investment review

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 [a]

	One year 02.10.17 % [b]	Three years 01.10.15 % p.a.	Five years 01.10.13 % p.a.	Since launch % p.a.
Sterling [c]				
Class 'A'	-0.4	+4.1	+3.5	+6.4 [d]
Class 'I'	+0.1	+4.6	+3.9	+6.9 [d]

[a] On 2 December 2008 the M&G Optimal Income Fund de-merged from M&G Investment Funds (6) to become the M&G Optimal Income Fund.

[b] Absolute basis.

[c] Price to price with income reinvested.

[d] 8 December 2006, the launch date of the predecessor OEIC sub-fund.

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

In the latter stages of 2017, investors' attention had turned to the likelihood of central banks finally being able to move towards more 'normal' monetary policy and gradually withdraw the support they had been providing to financial markets since the global financial crisis. This took place against a backdrop of broadly positive economic data releases, indicating a healthy global economy.

The Federal Reserve increased US interest rates three times during the review period, in December 2017, March 2018 and June 2018, taking the total number of times it has increased rates since the end of the financial crisis to seven.

The European Central Bank (ECB) announced in October 2017 that it would gradually reduce the amount of money it spends each month on its bond-buying programme, but would continue to support markets until at least September 2018. In June this year, the ECB announced it would halve its bond purchases in September and end them altogether in December.

Meanwhile, the Bank of England announced a small interest rate rise of a quarter of a percentage point in November 2017, taking rates back to their level immediately before 2016's Brexit referendum vote. It then increased interest rates by the same amount again in August 2018, taking them to 0.75%. However, with Brexit uncertainty still looming large over the outlook for the UK economy, any further rises are expected to be limited and gradual.

But after a broadly positive end to 2017 and a strong January 2018 for financial markets, many areas in the global bond market experienced a downturn, as investors reacted to the prospect of higher inflation and interest rates. By March, weakness in global stockmarkets, caused mainly by the prospect of a trade war between the US and China and the US imposition of sanctions on Russia, had started to spill over into corporate bond markets. While April proved somewhat calmer, Italian political turmoil, combined with ongoing trade tensions between the US and China, caused further volatility in May. Volatility returned once more in August, as concerns over Turkey's economy and government – which had been building for months – reached boiling point. The collapse of the Turkish lira had dramatic implications for other emerging markets, exacerbated by a rising US dollar and protracted trade wars.

The more challenging conditions from the start of 2018 led to muted returns across the bond market over the 12-month review period as a whole. Sterling and euro-denominated corporate bonds were generally flat over the period, very slightly ahead of US dollar corporate bonds. Within core government bond markets, US Treasuries declined, while UK and European government bonds rose slightly.

In these circumstances, the fund delivered mixed returns, although its relative lack of sensitivity to changes in interest rates (known as duration) helped to protect it from some of the worst volatility.

Investment activities

We adjust the positioning of the M&G Optimal Income Fund to reflect changes in our outlook regarding interest rates, credit risk (companies' ability to repay their debts) and changes in relative value among the different fixed income asset classes.

Having reduced our exposure to high yield corporate bonds in mid-2017 in favour of investment grade corporate bonds, which we considered to offer better value following the former's sustained outperformance, we maintained our low weighting to the asset class. Within investment grade, we are finding most opportunities within high quality, highly rated, corporate issues.

US dollar-denominated corporate bonds have outperformed euro and sterling-denominated corporate bonds over a sustained period and, as a result, we undertook a number of relative value trading opportunities – selling, for example, US dollar bonds issued by Goldman Sachs, Verizon and HSBC in favour of bonds from the same issuers denominated in sterling.

We can invest a portion of the fund (up to 20%) in shares if we believe a company's shares (equity) present a more attractive investment opportunity relative to its bonds. We didn't make any significant changes to our equities exposure, which ended at around 4.5%.

One of the key drivers of the fund's performance is the ability to reduce or increase the portfolio's sensitivity to changes in bond yields, otherwise known as 'duration'. (Bond yields refer to the interest received from a fixed income security, which is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value. Bond yields typically move in the opposite direction to bond prices.) The longer the duration, the more sensitive a bond/bond fund is to movements in interest rates. We maintained the fund's short duration during the entire period, as we believe that interest rates will likely rise further in the medium term. At the end of September 2018, the fund's duration stood at 2.2 years.

Outlook

From a macroeconomic perspective, we believe the global economic recovery remains on track. In the US, consumer confidence is at its highest level since the financial crisis, while a healthy labour market is expected to drive further wage growth over the coming months. Various key economic indicators look especially encouraging, with the recent surge in the number of people changing jobs strongly indicative of a future rise in wages.

Europe is also an improving economic story, in our view: its growth outlook has brightened and, while we saw significant market reaction to Italian political uncertainty in May, overall political risk has receded. As the ECB slowly continues to reduce the amount of support it provides to bond markets, this may have an impact on bond prices.

While the current period of economic growth may appear long compared to historic standards, we believe we are witnessing an unusually elongated economic cycle and so this slow and steady expansion is likely to persist. As a result, we want to retain a large exposure to corporate bonds, while maintaining the fund's relative lack of sensitivity to changes in interest rates.

We continue to monitor closely the possible impact on markets should the US Federal Reserve be forced to raise interest rates higher or faster than investors currently expect due to the rapid onset of inflation. The form of the UK's future relationship with the EU after its departure from the union is the other main potential challenge, as the clock ticks down towards the end of March 2019. The outcome will have a major impact on whether we find ourselves in a more stable, or more challenging, political environment in the next few years. At the same time, political newsflow – from the US in particular – may cause further volatility, as we have seen during the escalating trade tensions between the US and China.

Regardless of how these situations develop, what we do as fund managers does not change. We look at where we are in the interest rate cycle and the economic cycle, and we look at where we can find the most attractive opportunities for the fund from different sectors and individual issuers at any given stage.

Richard Woolnough
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.

Investment review

Classification spread of investments

The table below shows the percentage holding per sector.

	% of fund as at 2018	2017
EQUITIES		
Oil & gas producers	0.02	0.01
Oil equipment, services & distribution	0.00	0.00
Chemicals	0.00	0.11
Mining	0.00	0.00
Support services	0.05	0.04
Automobiles & parts	0.80	0.96
Tobacco	0.37	0.00
Pharmaceuticals & biotechnology	0.59	0.65
Media	0.00	0.36
Travel & leisure	0.04	0.00
Fixed line telecommunications	0.25	0.00
Electricity	0.20	0.25
Banks	1.68	0.23
Non-life insurance	0.53	0.00
Technology hardware & equipment	0.00	0.06
Non-convertible preference shares	0.02	0.03
FIXED INCOME		
Debt securities		
'AAA' credit rated bonds	12.69	20.80
'AA' credit rated bonds	20.43	9.71
'A' credit rated bonds	8.05	5.78
'BBB' credit rated bonds	36.69	40.36
'BB' credit rated bonds	9.06	8.72
'B' credit rated bonds	1.42	2.47
'CCC' credit rated bonds	0.10	0.11
Bonds with no credit rating	3.64	5.06
Debt derivatives		
Credit default swaps	0.05	0.05
Interest rate swaps	0.19	0.10
Interest rate futures	0.51	0.23
CURRENCY		
Forward currency contracts	0.24	1.45
CASH EQUIVALENTS		
'AAA' rated money market funds [a]	1.21	1.19
SHARE CLASS HEDGING		
Forward currency contracts for share class hedging	(0.45)	(1.84)

[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 Optimal Income Fund, 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 Optimal Income Fund, 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

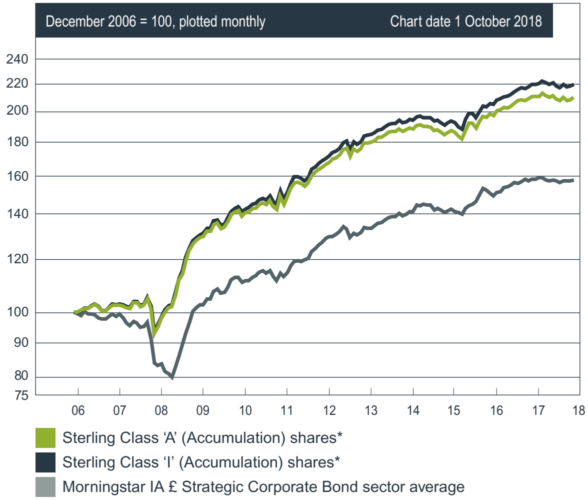
as at 30 September	2018 £'000	2017 £'000	2016 £'000
Fund net asset value (NAV)	23,097,567	20,637,023	15,426,945

Financial highlights

Fund performance

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

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 8 December 2006.

for the year to 30 September Change in NAV per share	2018 UK p	2017 UK p	2016 UK p
Opening NAV	208.53	196.82	185.07
Return before operating charges and after direct portfolio transaction costs	3.35	14.56	15.36
Operating charges	(2.95)	(2.85)	(2.67)
Return after operating charges	0.40	11.71	12.69
Distributions	(3.09)	(3.89)	(4.70)
Retained distributions	3.09	3.89	3.76
Closing NAV	208.93	208.53	196.82
Direct portfolio transaction costs	**UK p**	**UK p**	**UK p**
Costs before dilution adjustments	0.03	0.01	0.02
Dilution adjustments [a]	0.00	0.00	(0.01)
Total direct portfolio transaction costs	0.03	0.01	0.01
Performance and charges	**%**	**%**	**%**
Direct portfolio transaction costs [b]	0.02	0.01	0.00
Operating charges	1.41	1.40	1.41
Return after operating charges	+0.19	+5.95	+6.86
Distribution yield	1.81	1.26	2.10
Effect on yield of charges offset against capital	0.00	0.00	0.00
Other information			
Closing NAV (£'000)	518,684	567,587	650,497
Closing NAV percentage of total fund NAV (%)	2.25	2.75	4.22
Number of shares	248,252,722	272,182,254	330,507,238
Highest share price (UK p)	213.47	209.59	198.72
Lowest share price (UK p)	206.80	195.86	179.84

Financial highlights
Fund performance

Sterling Class 'I' Accumulation share performance

The share class was launched on 8 December 2006.

for the year to 30 September Change in NAV per share	2018 UK p	2017 UK p	2016 UK p
Opening NAV	217.46	204.22	191.26
Return before operating charges and after direct portfolio transaction costs	3.49	15.15	15.92
Operating charges	(1.99)	(1.91)	(1.79)
Return after operating charges	1.50	13.24	14.13
Distributions	(4.33)	(5.09)	(5.84)
Retained distributions	4.33	5.09	4.67
Closing NAV	218.96	217.46	204.22
Direct portfolio transaction costs	**UK p**	**UK p**	**UK p**
Costs before dilution adjustments	0.03	0.01	0.02
Dilution adjustments [a]	0.00	0.00	(0.01)
Total direct portfolio transaction costs	0.03	0.01	0.01
Performance and charges	**%**	**%**	**%**
Direct portfolio transaction costs [b]	0.02	0.01	0.00
Operating charges	0.91	0.91	0.91
Return after operating charges	+0.69	+6.48	+7.39
Distribution yield	2.31	1.76	2.60
Effect on yield of charges offset against capital	0.00	0.00	0.00
Other information			
Closing NAV (£'000)	1,527,682	1,448,476	1,400,480
Closing NAV percentage of total fund NAV (%)	6.61	7.02	9.08
Number of shares	697,689,230	666,103,023	685,772,367
Highest share price (UK p)	222.98	218.55	206.15
Lowest share price (UK p)	216.46	203.38	186.13

[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.
- **Share class hedging:** Charge paid to M&G for currency hedging services to minimise exchange rate risk for the share class.
- **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 30 September 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	(0.01)	0.00
Total direct portfolio transaction costs	0.02	0.01	0.00	0.01
as at 30 September Indirect portfolio transaction costs	**2018 %**	**2017 %**	**2016 %**	**Average [a] %**
Average portfolio dealing spread	0.48	0.56	0.72	0.59

[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

Notes

Contact

Customer Relations*

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** 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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