M&G Recovery Fund

a sub-fund of M&G Investment Funds (3)

Annual Short Report June 2019
For the year ended 30 June 2019

Fund information

The Authorised Corporate Director (ACD) of M&G Investment Funds (3) presents its Annual Short Report for M&G Recovery 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 (3), 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 8 April 2019, M&G Recovery Fund launched the Sterling Class 'PP' Accumulation shares.

As mentioned in the shareholder letter on 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 which are shown in the Key Investor Information Document (KIID) for the share class(es) you are invested in, visit our website www.mandg.co.uk.

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

Investment objective and policy up to 28 February 2019

The fund predominantly invests in a diversified range of securities issued by companies which are out of favour, in difficulty or whose future prospects are not fully recognised by the market. The sole aim of the fund is capital growth. There is no particular income yield target.

Investment approach up to 28 February 2019

The M&G Recovery Fund invests in companies that are out of favour with the stockmarket where a good management team is making concerted efforts to turn the business around. The fund manager takes a long-term view with a typical holding period of five years or more and aims to provide a diversified portfolio of up to 100 stocks. Developing a constructive dialogue with company management is a fundamental part of the investment process and the fund manager will not invest in a company unless he has met the management team first.

Investment objective from 1 March 2019

The fund aims to provide a higher total return (the combination of capital growth and income), net of the ongoing charge figure, than that of the FTSE All-Share Index over any five-year period.

Investment policy from 1 March 2019

At least 80% of the fund is invested directly in equity securities and equity-related securities of companies across any sectors and market capitalisations that are incorporated, domiciled, listed or do most of their business in the United Kingdom.

The fund may also invest in other transferable securities directly and via collective investment schemes (including funds managed by M&G).

The fund may also hold cash and near cash for liquidity purposes.

Derivatives may be used for efficient portfolio management and hedging.

Investment approach from 1 March 2019

The fund employs a disciplined approach to investment which concentrates on the analysis and selection of individual companies.

Recovery investing focuses on companies that have experienced difficulties but have the potential to deliver returns for shareholders through their turnaround over the long term.

The fund looks to benefit from the market's inefficiency in valuing companies going through short-term challenges. This enables the fund manager to identify companies whose long-term prospects have been underappreciated by the market.

When analysing a company, the fund manager focuses on three key factors: people, strategy and cashflow. Developing a constructive dialogue with company management is fundamental to the investment process.

The investment approach means the fund manager is prepared to take a contrarian view and consider areas that are out of favour with other investors. To take this contrarian view, the fund manager focuses on company management, their turnaround strategy and the businesses' ability to generate cashflow.

The fund manager expects individual cases of companies recovering to be the main driver of performance rather than individual sectors and the macroeconomic environment.

The fund manager takes a long-term view with a typical holding period of five years or more.

Risk profile

The fund invests in the shares of UK-listed companies and is, therefore, subject to the price volatility of the UK stockmarket and the performance of individual companies. The fund's focus is on companies that are out of favour with the market, and these stocks could potentially experience a degree of illiquidity in times of market distress. However, the fund is mainly invested in the shares of large and medium-sized companies, which are normally traded with relative ease. The fund also invests in the shares of smaller and AIM-listed companies, which can be more unpredictable and difficult to buy and sell. Diversification across industries and market capitalisation is therefore key in managing liquidity risk and reducing market risk. The fund's risks are measured and managed as an integral part of the investment process.

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.

Introduction by the fund manager

Dear Shareholder,

The M&G Recovery Fund marked its 50th anniversary on 23 May 2019. Although it is not M&G's oldest fund, Recovery is certainly the firm's most iconic and known throughout the financial services industry.

Since launch in 1969, the fund has only had three investment managers, which is a most unusual feat and this stable foundation has enabled a consistency of approach that is hard to find elsewhere in the UK. We have stayed faithful to the original concept of buying undervalued companies that are out of favour but run by capable people who have the ability to turn their businesses around. The beauty of this concept is that it means the fund can benefit from a change in the fortunes of individual companies even when economic or market conditions are not necessarily all that favourable. I would add here that the fund tends to be invested in companies that manufacture or produce things, be they from a factory or out of the ground, although this is not prescriptive.

As a fund manager, I am a strong believer in only investing in things we think we understand and prefer to concentrate on UK-listed stocks where M&G has long enjoyed a natural edge. The portfolio is well diversified across a wide range of companies, all at different stages of recovery, and although things are never straightforward, we believe long-term investors will be well rewarded and should not be deflected or distracted by the short-term noise of the market. We do not, for example, indulge in unnecessary trading of shares and we avoid often overpriced and over-hyped new issues. Furthermore, we steer clear of derivatives of all types and disapprove of the practice of stock lending which simply provides ammunition for short sellers of our holdings.

Our long-term approach allows us to build positions in companies in the early stages of their turnaround, where negative market commentary and public opinion is reflected in depressed share prices. The approach is anchored in three critical components: people, strategy and cashflow, which have been a hallmark of the fund for the entire 50 years.

Investment ideas are generated from a variety of sources, including my trusted and capable team, valued third parties and various intermediaries. We also travel widely while carrying out our research. But we are selective about the companies we back and work closely with our analysts, along with the corporate finance team, and speak to many people in the industry first to ensure we understand the challenges, risks and opportunities. Each new holding has to add something to the fund. Given that we are investing when a company is struggling and the share price is reflecting a poor outcome, that can require patience. However, we are not blind to the fact that 'value traps' exist.

Although the Recovery Fund does not deliver performance in a straight line, its potential remains considerable. Despite having to weather an extended period of underperformance, we have stuck to our recovery proposition and have been clear about it, and been sorely tested for doing so. We are not seeking to outperform every year, as we are investing in companies that are severely undervalued, and revaluations of them by the market are not always straightforward, but can be pronounced when they eventually occur. Indeed, a number of the fund's holdings have made considerable operational progress in the past few years that has not been recognised by the market. For example, the list includes such diverse businesses as resource companies BP, Tullow Oil, Kenmare Resources and St Barbara, construction group Balfour Beatty, biotechnology firm Oxford Biomedica, plus the clearing banks RBS and Lloyds.

Income plays no part in the formulation of the fund's policy. However, M&G has a history of encouraging companies to pay out dividends and, in recovery situations, a company re-joining the list of dividend payers is often seen by us and the market as a signal of returning confidence in the business, as well as a strong indication that the turnaround is on track. We have around 80 companies in the portfolio currently and only half are paying a dividend, which we believe reinforces the view that our investment approach remains true to its original aim of backing the underdog.

A trend that has been around for a while, but is attracting more attention these days, is the focus on investing in companies that pursue environmentally friendly and socially responsible policies, together with ensuring that corporations maintain good standards in their conduct of business and towards their employees. This more ethical approach to investment is collectively known as ESG (environmental, social and corporate governance). I see the Recovery Fund as one of the earliest to embrace these principles. Over the five decades, we have engaged with companies (met the managements before investing and voted at their meetings), helped them restructure, provided financing where necessary and encouraged them to improve their corporate governance practices. In the process, we have helped retain and create thousands of jobs, supported the development and launch of new drugs and medical devices, and aided hundreds of companies to return to profit.

Investment review

A recent market issue has been the liquidity of investment funds, or their ability to raise assets in order to meet redemptions. I should like to reaffirm that the Recovery Fund has been well aware of this issue for years, and around 40% of the portfolio is maintained in the larger more liquid companies represented by the FTSE 100 Index. Notably, as a recovery plan in a company gathers pace, it is normal to expect liquidity in its shares to increase.

In terms of Brexit, I do not believe the Recovery Fund is particularly overly exposed, except that the majority of the portfolio is invested in the UK stockmarket. Be that as it may, approximately three-quarters of the revenues generated by the companies in the portfolio are derived from overseas. My view remains one of great future opportunity for the UK, notwithstanding the political maelstrom of the past three years.

I should like to end by observing that the Recovery Fund achieves what the stockmarket was created for, which was a way for getting capital to companies and achieving returns for those prepared to take risk, whereas today, investing seems to be regarded as a casino. The fund is not a charity, but in fulfilling its mandate over the past 50 years, and participating in rights issues and placings, we have saved countless companies and provided an unquantified societal benefit in the process.

Finally, thank you for your continued support for M&G and the Recovery Fund.

Tom Dobell

Fund manager of the fund

As at 1 July 2019, for the year ended 30 June 2019

Performance against objective

The M&G Recovery Fund invests in companies that, at the time of investment, are out of favour with the stockmarket, and where the fund manager believes a good management team is making concerted efforts to turn the business around. The fund's objective is to outperform the FTSE All-Share Index (net of charges) over any five-year period.

Between 2 July 2018 (the start of the review period) and 1 July 2019, the fund produced a negative total return (the combination of income and growth of capital) across all share classes. The fund's returns in all share classes were behind that of the FTSE All-Share Index. Over the same period, returns for the index were 3.4% and 1.9% in sterling and euros, respectively.*

Over five years, the fund also lagged the FTSE All-Share Index, therefore missing its objective.

* 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 (3).

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 02.07.18 % [a]	Three years 01.07.16 % p.a.	Five years 01.07.14 % p.a.	Since launch % p.a.
Sterling [b]				
Class 'A'	-9.2	+6.6	+0.9	+13.3 [c]
Class 'I'	-8.5	+7.4	+1.6	+4.2 [d]

[a] Absolute basis.

[b] Price to price with income reinvested.

[c] 23 May 1969, the end of the initial offer period of the predecessor unit trust.

[d] 15 January 2010, 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 fund delivered negative returns over the 12-month review period and underperformed its comparative index, the FTSE All-Share Index. This was due to the adverse market conditions in the first half and the fund's differentiated positioning relative to the market. In addition, the portfolio consists of companies that are mostly on the mend and therefore perceived to be high risk, even if they are very attractively valued. Consequently, the past 12 months has been disappointing in performance terms for most investors, but the fund has been particularly vulnerable. Nevertheless, there were some encouraging developments, especially within the fund's holdings in biotechnology companies, even if, ultimately, these were not recognised by the market in the short term.

UK company shares (equities) were volatile over the 12 months. Like other major stockmarkets, the UK was in decline during the second half of 2018 as investors became concerned that the US economy was slowing, just as the effect of President Trump's tax cuts was beginning to wane. Sentiment was also hurt due to the ongoing trade war between the US and China, despite encouraging signs that some form of agreement was imminent in the spring.

Investors' risk appetite improved significantly at the start of 2019 after the US Federal Reserve indicated a slower approach to interest rate hikes, due to the global economic slowdown, lower oil prices and muted domestic inflation. Heightened trade tensions between the US and China led to stockmarket weakness late in the period under review, before hopes of lower US interest rates, as well as some reconciliation on trade, led to a partial recovery. Against this backdrop, the UK stockmarket made very modest progress over the 12 months.

In terms of political developments, the UK's Brexit talks continued to dominate the headlines. Former prime minister Theresa May secured a withdrawal agreement with the European Union, but the House of Commons rejected the deal three times. The original date for Brexit passed, along with its successor in April, and a new deadline of 31 October 2019 was agreed. In other developments, Mrs May announced her resignation in May, triggering a leadership contest.

UK economic activity is uninspiring, with domestic companies affected by uncertainty relating to Brexit as well as slower growth in the global economy. Meanwhile, interest rates stand at 0.75% after the Bank of England raised them by a quarter of a percentage point in August 2018. Future changes are likely to be closely connected to developments in the Brexit negotiations and prospects for the economy.

Larger companies outperformed over the 12 months as they benefited from the boost to their overseas revenues from the pound's Brexit-related weakness. Conversely, more domestically focused medium-sized and smaller companies underperformed, reflecting the flagging economy, higher import costs and a slowdown in business investment.

Miners, beverages, pharmaceuticals, media, non-life insurance, financial services and technology outperformed. In contrast, chemicals, industrials, tobacco, retailers, banks, travel & leisure, telecoms and utilities were among the weakest. Notably, consumer staples (excluding tobacco) companies attracted support, reflecting their steady earnings growth characteristics. Technology was helped by the strength of the US sector, but it is a very small part of the UK market. The energy sector was lacklustre, as the oil price ended the 12-month period down slightly at US$67 per barrel from US$77 at the start, although this disguised a rise to above US$86 in October, followed by a steep fall to US$50 by the end of 2018, before supply constraints, US sanctions and tensions with Iran over tankers in the Gulf caused the trend to reverse.

Amongst the fund's top contributors to performance over the 12-month period were biotech firm GW Pharmaceuticals, pub operator Ei, tech group Micro Focus, emergency home cover supplier HomeServe, flexible workspace provider IWG, coal producer MC Mining and media company Entertainment One. In addition, sector allocation made a positive contribution, principally through avoiding tobacco stocks in the portfolio, which sold off sharply in 2018 and have staged only a partial recovery so far in 2019.

GW Pharmaceuticals recovered from a short-lived sell-off driven by risk aversion at the end of 2018. The company is making considerable progress in the US commercialising Epidiolex, its ground-breaking treatment for severe epilepsy in children. Ei (formerly Enterprise Inns) benefited from the announcement that it intended to sell some of its property portfolio. Micro Focus' shares have doubled since being added to the portfolio following their collapse last year. The market rewarded the software firm after the results showed it was beginning to recover from its acquisition of HP Enterprise's software business. HomeServe held a well-received capital markets day where it published new targets for the main business and its online portal Checkatrade. IWG was helped by the successful franchising of its Japanese business, which has been sold recently for a price materially above its UK stockmarket rating. Shares in MC Mining, which produces high-quality coking and thermal coal, rallied after it was granted some mining rights for a South African project after a five-year wait. Entertainment One is delivering on growth expectations for its franchises, Peppa Pig and MGC, and is seeing increased success in its television content division.

Conversely, the main detractors included biotech firms Oxford Biomedica and Hutchison China MediTech – with the former succumbing to profit-taking, and the latter affected by a share sale at a 20% discount to the market by its parent company for accounting purposes. Encouragingly, the Hutchison stock was snapped up by institutional investors and the company issued a very positive update on Surufatinib, its treatment for non-pancreatic tumours, which means it can stop the Phase III trial early, bringing it closer to the formal approval and production stage. In addition, a new holding, Kier announced that it had made a loss in its first half and cut the dividend. However, Kier is in the early stages of the recovery cycle, has a full order book and is potentially a strong cash generator. Elsewhere, easyJet, the low-cost carrier, was weaker on poor first-half results which it blamed on Brexit uncertainty, a late Easter and the Gatwick drone disruption; we took the opportunity to add to the fund's position as easyJet is a solid business with good growth opportunities. In the resources sectors, some of the fund's positions (First Quantum Minerals, Bluejay Mining, Tullow Oil, Nostrum Oil & Gas) were affected by weakening demand for raw materials and the fall in the oil price.

Investment activities

We made six new purchases and five complete sales over the year in accordance with our one-in-one-out policy. In addition, a holding went into liquidation – we expect at least one business to fail per annum on the fund.

Positions were established in construction firm Kier, oil services supplier Petrofac, corporate broking firm plus wealth manager WH Ireland, energy infrastructure firm National Grid and cardboard packaging manufacturer Smurfit Kappa, along with gold and silver miner Troy Resources.

Kier is a smaller company, which undertakes infrastructure projects for the government, NHS and local authorities. Kier came to the portfolio after we underwrote part of what became a troubled rights issue by the company that failed as the share price collapsed below the issue price for technical reasons rather than fundamentals. As the fund was left holding the stock, we decided to increase the position by participating in the placing by other underwriting institutions that did not want to be investors in Kier. The company appointed a new chief executive in April who has announced a strategic review and sale of some non-core businesses.

Petrofac is a medium-sized company specialising in large oil projects, mainly in the Middle East and Asia. It made a strategic error by increasing its downstream production and refining activities, which came under pressure from a falling oil price, leaving the company with excessive levels of debt in a complex business. Petrofac is in the process of withdrawing from these areas and expects this to leave it in a cash-positive position. Another issue for the company is that it has been under investigation by the Serious Fraud Office (SFO), which resulted in the chief executive being arrested in May 2017, causing the shares to fall sharply. Petrofac could afford to pay a fine if it was felt that was appropriate; however, the SFO have produced no evidence of wrongdoing (it is not obliged to), and while the company has cooperated with the investigation, it has struggled to understand what it is meant to have done. Petrofac has a sensible board and a good track record. We have carried out a thorough due-diligence check on the business and have met the chairman (ex finance director of Anglo American) and chief executive, Ayman Asfari, who is also the founder, and agree with the many businesses in the industry that show their confidence in him by continuing to fill the firm's order book.

Listed on AIM (Alternative Investment Market), WH Ireland is another company where the shares have been under pressure due to issues with the regulator. We believe that the two parts to WH Ireland's business, corporate broking and wealth management, together with a large cash balance for its size, are worth more than its market capitalisation (number of WH Ireland shares in issue multiplied by the share price). The wealth management business has a private client book worth approximately £1 billion and includes eight regional offices in the UK and the Isle of Man.

Utilities have been a painful area of the market, due to the threat from increased regulation and nationalisation. National Grid recently announced full-year profits that had fallen by nearly a third, which it blamed on one-off factors in the UK such as the cancellation of two nuclear power stations, a seven-month labour dispute in the US that has been resolved, as well as restructuring programmes in the US and UK. However, valuations look attractive and over 50% of National Grid's business is in the US and performing very well.

Smurfit Kappa is a Dublin-based, FTSE 100-listed company that has suffered from cyclical pricing issues in the paper market, as well as the devaluation of the bolivar and seizure of one of its plants in Venezuela late last year. The authorities accused Smurfit Kappa of price speculation and destabilising the Venezuelan economy, which it denies. Although a small part of its international business, the write-down of its assets in Venezuela caused the company's annual results to swing into loss.

Troy Resources was the final purchase during the period. We took advantage of a capital-raising exercise in May to start a small position. The gold and silver miner has operations in Australia and South America – in particular the Karouni gold mine in Guyana.

We also participated in a number of refinancings of existing holdings, the most significant of which were Mercantile Ports & Logistics, Mothercare and African low-cost carrier Fastjet. In the case of the former, the refinancing resulted in the fund establishing a substantial holding in the Indian port developer and operator, which is building a new port in Mumbai where the state-run dockside facilities have become clogged-up. We believe the company's valuation is appreciably below its true worth and expect it to ramp-up its freight-handling sales. In a very good sign for the future of the business, a local firm has taken a 22% stake in the company as it also recognises the potential.

Sales included three companies in stage 1 (unloved) of our recovery process: Dixons Carphone, African Petroleum and Saga. These had been long-term holdings, but had not made satisfactory progress with improving their operational performance, leading to a loss of conviction in their investment case. Dixons Carphone was originally acquired as Carphone Warehouse and performed well initially, enabling us to exit most of the position profitably earlier on, but the share price has been lacklustre recently. The other complete sales were UDG Healthcare, a provider of medical equipment and healthcare services to the pharmaceutical sector, and insurer Prudential. Shares in both companies had enjoyed a significant run-up and their businesses had reached stage 3 (recovering well) of our recovery process.

KSK Power Venture, a stage 1 company, went into liquidation. The Indian power generator had quite high leverage and was affected by a change in the law, due to a banking crisis in India, requiring banks to foreclose on their debts to power companies and as a result KSK Power Venture lost control of its main assets.

In other activity, we realised some profits in other stage 3 holdings such as biotechnology firm GW Pharmaceuticals, emergency repairs business HomeServe, media group Entertainment One, pub operator Ei, industrial thread manufacturer Coats and tech firm Micro Focus, as well as a stage 4 (mature) holding, cruise line operator Carnival. The proceeds were recycled into some of our more recently acquired stage 1 holdings, including outsourcer Capita and African gold miner Hummingbird Resources. We also took the opportunity to increase another stage 1 company, BT, which has been held in the portfolio for some time. The telecoms group's shares had fallen 20% over the first six months of 2018 and looked friendless and overly cheap. Elsewhere, we took some cash out of Lloyds Banking, as the shares underwent a very strong run-up in the new year on the back of a positive outlook for revenue growth in 2019 and short-lived optimism about the global economic outlook.

Outlook

The UK equity market has proved to be remarkably sanguine so far this year, notwithstanding a deterioration in the economic outlook at home and abroad, an increase in trade tensions between the US and its major trading partners, sabre rattling in the Strait of Hormuz and concerns around Brexit.

The main reasons behind the market's support have been the Bank of England's maintenance of a low interest rate policy together with the ultra-low level of bond yields – the benchmark 10-year gilt yield is currently at 0.56%. Another factor, however, has been a remarkably resilient consumer until now, helped by unemployment at a 44-year low and wage growth that has finally overtaken the inflation rate. In addition, UK equities began 2019 looking relatively cheap as investors reacted to the increased uncertainty over Brexit. Despite this year's rally, the UK equity market still represents fair value compared to other equity markets, although it is likely to remain at a discount to them until the complexity of the Brexit process has run its course.

Sterling has tended to be more immediately reflective of the Brexit outlook and it is expected to rally if 'no deal' is avoided, and sell off sharply in the wake of a hard Brexit. A deal would also support the equity market, especially domestic stocks, and may potentially reduce the risk of a Labour government, worries about which have also acted as a restraint on the market's upward progress. But even in the circumstances of a no-deal scenario, with 75% of FTSE 100 companies' earnings derived from overseas, the market should find some support.

Longer term, UK companies' balance sheets are well capitalised, and earnings and dividend growth supportive, assisted by the Bank of England's stimulative monetary policy.

Tom Dobell
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.

Portfolio statement

as at 30 June Holding		2019 £'000	2019 %	2018 [a] %
	EQUITIES	2,210,023	99.92	100.19
	Software & computer services	**58,197**	**2.63**	**1.78**
6,615,674	Actual Experience [b]	9,923	0.45	
11,302,515	Blancco Technology [b]	14,128	0.64	
120,629,158	eServGlobal [b]	6,273	0.28	
1,252,696	Micro Focus International	25,837	1.17	
2,916,666	Watchstone [b]	2,036	0.09	
	Technology hardware & equipment	**2,465**	**0.11**	**0.18**
7,951,272	Frontier Smart Technologies	2,465	0.11	
	Telecommunication service providers	**36,710**	**1.66**	**1.34**
27,359,073	Avanti Communications [b]	439	0.02	
18,500,000	BT	36,271	1.64	
	Medical equipment & services	**0**	**0.00**	**0.28**
	Pharmaceuticals & biotechnology	**335,785**	**15.18**	**13.57**
5,356,802	Eco Animal Health [b]	19,820	0.90	
1,000,000	GW Pharmaceuticals ADR	134,132	6.06	
2,340,838	Hutchison China Meditech ADR	55,645	2.51	
54,539,412	Mesoblast	44,419	2.01	
1,038,939	Mesoblast ADR	4,119	0.19	
11,156,679	Oxford Biomedica	77,650	3.51	
	Banks	**349,133**	**15.78**	**14.38**
28,400,000	HSBC	186,361	8.42	
130,480,000	Lloyds Banking	74,269	3.36	
17,600,000	Royal Bank of Scotland	38,491	1.74	
7,030,000	Standard Chartered	50,012	2.26	

Portfolio statement (continued)

as at 30 June Holding		2019 £'000	2019 %	2018 [a] %
	Investment banking & brokerage services	**23,772**	**1.08**	**1.19**
17,657,142	IP	13,207	0.60	
2,550,000	TP ICAP	7,678	0.35	
6,415,444	WH Ireland [b]	2,887	0.13	
	Equity investment instruments	**4,722**	**0.21**	**0.15**
410,580	Gresham House Strategic [b]	4,722	0.21	
	Life insurance	**33,327**	**1.51**	**5.16**
8,050,000	Aviva	33,327	1.51	
	Household goods & home construction	**11,239**	**0.51**	**0.29**
8,240,000	McCarthy & Stone	11,239	0.51	
	Media	**81,104**	**3.67**	**3.95**
11,500,000	Entertainment One	45,379	2.05	
16,600,000	ITV	17,820	0.81	
2,175,000	Pearson	17,905	0.81	
	Retailers	**20,674**	**0.93**	**2.27**
1,200,000	Dignity	7,836	0.35	
63,238,935	Mothercare	12,838	0.58	
	Travel & leisure	**166,644**	**7.53**	**8.97**
341,502	Carnival	11,874	0.53	
5,650,000	Dalata Hotel	24,102	1.09	
3,442,000	easyJet	32,052	1.45	
25,901,129	Ei	51,025	2.31	
745,331,981	fastjet	11,925	0.54	
9,321,340	fastjet wts. 2021	0	0.00	
8,850,000	National Express	35,666	1.61	
	Food producers	**30,348**	**1.37**	**1.57**
7,287,630	REA	9,620	0.43	
2,380,000	Tate & Lyle	17,602	0.80	
46,304,408	Zambeef Products [b]	3,126	0.14	
	Construction & materials	**101,993**	**4.61**	**4.21**
12,900,000	Balfour Beatty	31,270	1.41	
2,530,000	CRH	64,692	2.93	
5,548,239	Kier	6,031	0.27	
	Aerospace & defence	**73,388**	**3.32**	**2.82**
19,800,000	Cobham	20,909	0.94	
2,670,000	Meggitt	13,937	0.63	
4,350,000	QinetiQ	12,093	0.55	
1,980,000	Rolls-Royce	16,573	0.75	
146,309,150	TP [b]	9,876	0.45	

Portfolio statement (continued)

as at 30 June Holding		2019 £'000	2019 %	2018 [a] %
	Electronic & electrical equipment	**4,100**	**0.19**	**0.41**
5,000,000	Xaar	4,100	0.19	
	General industrials	**60,886**	**2.75**	**2.99**
35,000,000	Coats	28,402	1.28	
1,200,000	Smiths	18,732	0.85	
580,000	Smurfit Kappa	13,752	0.62	
	Industrial engineering	**33,794**	**1.53**	**1.41**
27,500,000	Renold [b]	8,965	0.41	
36,300,000	Severfield	24,829	1.12	
	Industrial support services	**166,061**	**7.51**	**6.41**
28,719,340	Capita	29,911	1.35	
4,500,000	Essentra	19,107	0.87	
1,680,000	Grafton	13,852	0.63	
2,650,000	HomeServe	31,455	1.42	
21,000,000	IWG	71,736	3.24	
	Industrial transportation	**37,102**	**1.68**	**1.67**
5,812,903	Avation	15,695	0.71	
346,934,550	Mercantile Ports [b]	6,592	0.30	
13,846,267	Stobart	14,815	0.67	
	Industrial metals & mining	**179,793**	**8.13**	**7.82**
13,456,784	Bacanora Lithium [b]	4,979	0.22	
103,636,364	Bluejay Mining [b]	7,337	0.33	
7,063,300	First Quantum Minerals	52,095	2.36	
13,500,000	Hummingbird Resources [b]	2,329	0.11	
17,855,335	Kenmare Resources	32,496	1.47	
40,788	Kenmare Resources wts. 2019	0	0.00	
23,346,347	MC Mining [b]	9,572	0.43	
1,355,000	Rio Tinto	65,650	2.97	
96,615,969	White Energy Company	5,335	0.24	
	Precious metals & mining	**64,274**	**2.91**	**2.93**
75,128,263	Petra Diamonds	14,845	0.67	
22,933,549	St Barbara	37,229	1.68	
28,247,500	Sylvania Platinum [b]	8,333	0.38	
74,500,000	Troy Resources	3,867	0.18	
	Non-renewable energy	**310,883**	**14.05**	**14.13**
37,400,000	BP	205,401	9.29	
16,622,508	Great Eastern Energy GDR	7,480	0.34	
12,000,000	Lamprell	7,848	0.35	
8,970,675	Nostrum Oil & Gas	4,261	0.19	
2,650,000	Petrofac	11,347	0.51	
87,688,530	Providence Resources [b]	7,278	0.33	
32,170,000	Tullow Oil	67,268	3.04	

Portfolio statement (continued)

as at 30 June Holding		2019 £'000	2019 %	2018 [a] %
	Electricity	**8,098**	**0.37**	**0.31**
49,079,566	OPG Power Ventures [b]	8,098	0.37	
	Gas, water & multi-utilities	**15,531**	**0.70**	**0.00**
1,860,000	National Grid	15,531	0.70	
	Unquoted / unlisted [c]	**0**	**0.00**	**0.00**
38,761,085	African Minerals	0	0.00	
39,868,814	Alizyme	0	0.00	
3,094,020	Izodia	0	0.00	
34,149,791	KSK Power Ventur	0	0.00	
Portfolio of investments		**2,210,023**	**99.92**	**100.19**
	CASH EQUIVALENTS	**8,051**	**0.36**	**0.00**
	'AAA' rated money market funds [d]	**8,051**	**0.36**	**0.00**
8,051,000	Northern Trust Global Fund - Sterling	8,051	0.36	
Total portfolio		**2,218,074**	**100.28**	**100.19**
Net other assets / (liabilities)		**(6,167)**	**(0.28)**	**(0.19)**
Net assets attributable to shareholders		**2,211,907**	**100.00**	**100.00**

All securities are on an official stock exchange listing except where referenced.

[a] The portfolio has been reclassified to more appropriately reflect how the fund is managed. 2018 comparatives have been restated to reflect this.

[b] AIM quoted.

[c] Suspended.

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

Investment review

Top ten portfolio transactions

for the year to 30 June 2019

Largest purchases	£'000
Kier	21,537
Petrofac	15,834
National Grid	15,691
Smurfit Kappa	14,099
Capita	9,795
Rolls-Royce	8,895
St Barbara	8,715
Mothercare	8,335
fastjet	7,744
ITV	6,404
Other purchases	44,432
Total purchases	**161,481**

Largest sales	£'000
Prudential [a]	74,209
BP	43,566
GW Pharmaceuticals ADR	41,790
Entertainment One	32,371
Ei	31,310
Carnival	30,558
HomeServe	25,074
Coats	21,948
Aviva	21,623
HSBC	19,696
Other sales	118,529
Total sales	**460,674**

[a] Related party to the fund.

Purchases and sales exclude the cost and proceeds of 'AAA' rated money market funds.

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 charts 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 (3), 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 (3), which is available free of charge either from our website at www.mandg.co.uk/reports or by calling M&G Customer Relations.

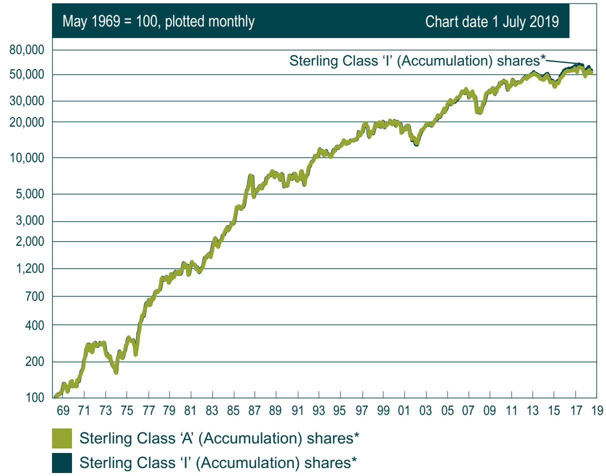
Fund level performance

Fund net asset value

as at 30 June	2019 £'000	2018 £'000	2017 £'000
Fund net asset value (NAV)	2,211,907	2,809,729	3,085,097

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.

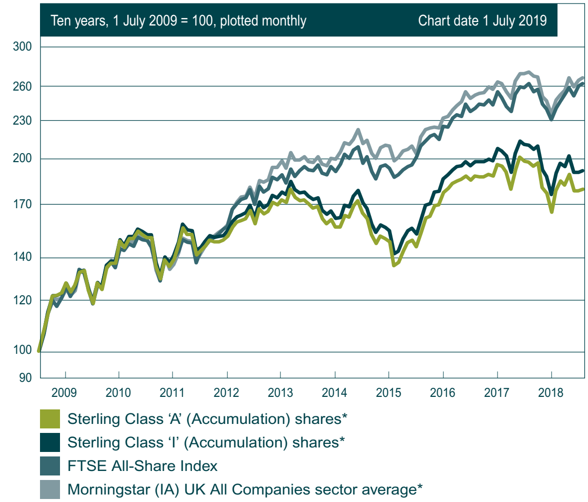


* Income reinvested

Source: Morningstar, Inc. and M&G

Ten-year performance

Please note that comparative data is not available from fund launch. Therefore a ten-year comparable performance chart is shown below.



* Income reinvested

Source: Morningstar, Inc. and M&G

The fund's Sterling Class 'I' (Accumulation) shares were launched on 15 January 2010. 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.

Historic yields for the current year are calculated as at 12 July 2019.

Sterling Class 'A' Accumulation share performance

The share class was launched on 23 May 1969.

for the year to 30 June Change in NAV per share	2019 UK p	2018 UK p	2017 UK p
Opening NAV	346.76	323.47	254.06
Return before operating charges and after direct portfolio transaction costs	(29.95)	28.80	74.38
Operating charges	(5.33)	(5.51)	(4.97)
Return after operating charges	(35.28)	23.29	69.41
Distributions	(3.91)	(2.46)	(1.22)
Retained distributions	3.91	2.46	1.22
Closing NAV	311.48	346.76	323.47
Direct portfolio transaction costs	**UK p**	**UK p**	**UK p**
Costs before dilution adjustments	0.10	0.11	0.15
Dilution adjustments [a]	(0.07)	(0.08)	(0.13)
Total direct portfolio transaction costs	0.03	0.03	0.02
Performance and charges	**%**	**%**	**%**
Direct portfolio transaction costs [b]	0.01	0.01	0.01
Operating charges	1.66	1.66	1.66
Return after operating charges	-10.17	+7.20	+27.32
Historic yield	1.24	0.71	0.37
Effect on yield of charges offset against capital	0.00	0.00	0.00
Other information			
Closing NAV (£'000)	536,905	634,597	769,199
Closing NAV percentage of total fund NAV (%)	24.27	22.59	24.93
Number of shares	172,372,639	183,009,631	237,792,926
Highest share price (UK p)	349.75	360.34	330.04
Lowest share price (UK p)	285.39	310.94	251.92

Sterling Class 'I' Accumulation share performance

The share class was launched on 15 January 2010.

for the year to 30 June Change in NAV per share	2019 UK p	2018 UK p	2017 UK p
Opening NAV	368.26	340.98	265.81
Return before operating charges and after direct portfolio transaction costs	(31.86)	30.48	78.06
Operating charges	(3.12)	(3.20)	(2.89)
Return after operating charges	(34.98)	27.28	75.17
Distributions	(6.73)	(5.24)	(3.68)
Retained distributions	6.73	5.24	3.68
Closing NAV	333.28	368.26	340.98
Direct portfolio transaction costs	**UK p**	**UK p**	**UK p**
Costs before dilution adjustments	0.11	0.11	0.15
Dilution adjustments [a]	(0.08)	(0.08)	(0.14)
Total direct portfolio transaction costs	0.03	0.03	0.01
Performance and charges	**%**	**%**	**%**
Direct portfolio transaction costs [b]	0.01	0.01	0.01
Operating charges	0.91	0.91	0.91
Return after operating charges	-9.50	+8.00	+28.28
Historic yield	2.00	1.43	1.06
Effect on yield of charges offset against capital	0.00	0.00	0.00
Other information			
Closing NAV (£'000)	468,848	643,242	672,526
Closing NAV percentage of total fund NAV (%)	21.20	22.89	21.80
Number of shares	140,675,920	174,669,140	197,234,721
Highest share price (UK p)	371.53	382.38	347.63
Lowest share price (UK p)	304.20	329.64	263.60

[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. 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 June Direct portfolio transaction costs [b]	2019 %	2018 %	2017 %	Average [a] %
Broker commission	0.01	0.01	0.03	0.02
Taxes	0.02	0.02	0.02	0.02
Costs before dilution adjustments	0.03	0.03	0.05	0.04
Dilution adjustments [c]	(0.02)	(0.02)	(0.04)	(0.03)
Total direct portfolio transaction costs	0.01	0.01	0.01	0.01

as at 30 June Indirect portfolio transaction costs	2019 %	2018 %	2017 %	Average [a] %
Average portfolio dealing spread	0.69	0.59	0.69	0.66

[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.

Contact

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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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