

M&G UK Income Distribution 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 UK Income Distribution 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 increase income distributions over time and targets a yield greater than that of the FTSE All-Share Index. Although income will be the primary consideration, the investment manager will also aim for capital growth.

Investment policy

At least 70% of the fund will be invested in UK equities. Exposure to UK equities may be gained by investing in other collective investment schemes.

The fund focuses on good-quality but undervalued stocks that offer a higher income than the FTSE All-Share Index by identifying those companies that exhibit the following qualities: strong business operations, good cash flows and attractive dividend growth prospects. The fund may also invest in sterling-denominated fixed income securities.

Cash and near cash may be held for ancillary purposes and derivatives may be used for efficient portfolio management and hedging purposes.

Investment approach

The M&G UK Income Distribution Fund is managed to provide investors with a high income through a portfolio of UK equities and high quality corporate bonds (in order to aid income generation). The fund targets a yield that is higher than that of the FTSE All-Share Index. Although this gives the fund a bias towards the higher yielding sectors of the market, it aims to have a broadly diversified portfolio within these yield constraints.

The equity component of the fund has a bias towards good value, out of favour stocks. Good quality investments are selected from the available universe of higher yielding equities by identifying those companies that exhibit the following qualities: strong business franchise, good cashflow characteristics and attractive dividend growth prospects.

Stocks will generally be sold if these criteria no longer apply, but the specific sell discipline is triggered by over-valuation, falling yield or better opportunities elsewhere.

The fixed income exposure will be comprised of issues chosen for high quality and broad diversification. Corporate bonds are typically favoured versus the risk-free rate (as proxied by gilts in the long term) in pursuit of income.

Risk profile

The fund invests mainly in the shares of UK-listed companies. It is also invested in high-quality, sterling-denominated fixed income securities, or bonds. The fund is, therefore, subject to the price volatility of the global bond and stockmarkets as well as the performance of individual companies. The fund is also subject to fluctuations in currency exchange rates. The fund has a bias towards the higher yielding sectors of the market, although it seeks to have a broadly diversified portfolio at the same time. Income distributions from the fund's holdings, however, are not guaranteed and may vary.

Diversification across industries and company sizes 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.

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

The fund achieved the objective of growing its income over the 12-month review period. In addition, as at 3 June 2019, the 5.08% yield on the fund's Sterling Class 'A' (Income) shares was 18% above the broad market FTSE All-Share Index yield of 4.31%, meeting the fund's target to exceed the index yield.

Two quarterly distributions of 6.40p per Sterling Class 'A' (Income) share were declared in respect of the first half of the review period, followed by a third quarterly distribution of 6.40p and a final quarterly distribution of 17.91p in respect of the second half of the review period. The fund's total distribution over the year of 37.11p represents an increase of 5.2% on the corresponding period last year. The latest annual inflation rate, as measured by the Retail Prices Index (RPI), was 3.0% in May, while on the Consumer Prices Index (CPI) measure it was 2.1%.

For details of the fund's historic yields for your specific share class, please refer to the 'Specific share class performance' tables in the 'Financial highlights' section of the Annual Long Report and audited Financial Statements for M&G Investment Funds (2).

Between 1 June 2018 (the start of the review period) and 3 June 2019, the fund delivered a negative total return (the combination of income and growth of capital) across all its share classes*, driven by a decline in capital value. Accordingly, over this time frame, the fund did not grow its capital, which is a secondary consideration after the income growth requirement. The fund's performance reflected the overall negative trend in share markets, while fixed income recorded modest gains, resulting in the fund trailing the -0.7% return by a comparable composite index that comprises 70% the FTSE All-Share Index and 30% the FTSE UK Conventional Gilts All Stocks Index.

* 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'	-2.6	+5.6	+4.4	+11.6 ^[c]
Class 'I'	-2.0	+6.2	+5.0	+7.5 ^[d]

^[a] Absolute basis.

^[b] Price to price with income reinvested.

^[c] 19 November 1973, 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

The 12 months under review was a period of contrasts, with marked declines in UK and many global stockmarkets in the second half of 2018, before a significant rally in the early months of 2019. These moves resulted in the UK stockmarket recording a modest decline over the period as the FTSE All-Share Index returned -3.3%.

Late 2018 saw a continuation of previous weakness on concerns about a slowing US economy, just as the effect of President Trump's tax cuts was beginning to wane, as well as US protectionism and the prospect of higher interest rates. Risk appetite improved dramatically in the new year, however, after the US Federal Reserve indicated a pause in interest rate hikes due to concerns about their economic impact, the sharp increase in market volatility and muted domestic inflation. In addition, investors were encouraged by some better-than-expected corporate results, signs of progress in the US-China trade talks, and news that China's central bank was boosting lending in the Chinese economy in response to slowing growth. There was a brief setback in March when some business sentiment data in the US and Europe disappointed, before stockmarkets, the UK included, resumed their upward trajectory, with the US reaching a new all-time high.

However, in the final month of the fund's year, investor sentiment deteriorated sharply as the US president surprised everyone by escalating his disputes over trade, initially with China but later taking aim at Mexico and India.

In the UK, Brexit increasingly dominated the headlines. Prime Minister Theresa May secured a withdrawal agreement with the European Union (EU), but members of parliament (MPs) rejected the deal three times, along with a number of indicative votes on alternative options put forward by MPs. The original 29 March 2019 deadline for Brexit came and went after the EU agreed to extend the process. With the aim of avoiding a departure with no deal in place on 12 April, the Prime Minister secured agreement to a new deadline of 31 October 2019, before announcing that she would step down as party leader on 7 June when she accepted that she had insufficient support for her deal in Parliament. This effectively put Brexit on hold until the outcome of the contest to find her replacement and new prime minister.

Sterling experienced a volatile 12 months, mainly as the currency responded to Brexit developments. The currency stood at around US\$1.33 at the start of the period, and passed lows of around US\$1.25 in December as investors contemplated the possibility of a messy outcome or a general election. It then recovered to US\$1.33 as 'no deal' appeared less likely in February, before settling at US\$1.26 by the end of May 2019 in the wake of the Prime Minister's resignation.

All company size categories declined over the 12 months, reflecting the market sell-off in 2018. Larger companies were more resilient overall, assisted by sterling weakness in 2018. However, medium-sized companies have outperformed so far in 2019. Currency has been a big driver, with sterling weakness last year boosting the overseas revenues of UK multinationals, while sterling strength since the start of 2019 has brought down import costs for more domestically focused medium-sized and smaller companies.

Sector performance was mixed, reflecting the mid-term market volte-face, with mining, oil & gas producers, consumer staples, pharmaceuticals, media, fixed line telecoms, water utilities, non-life insurance and technology companies outperforming, while oil services, chemicals, industrials, tobacco, healthcare equipment, consumer services, mobile telecoms, financials and electricity generators underperformed. 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\$66 per barrel, 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 and US sanctions caused the trend to reverse.

In the UK sterling bond, or fixed income market, the FTSE UK Conventional Gilts All Stocks Index returned 5.1%, while the Merrill Lynch Non-Gilts Sterling Bond Index returned 4.8%. In addition, longer dated government bonds significantly outperformed their shorter dated counterparts as they benefited from ongoing support from investors with long-term liabilities to match, such as pension funds and insurance companies. (Bonds are loans in the form of a security, usually issued by a government (government bonds) or company (corporate bonds), which normally pay a fixed rate of interest over a given time period, at the end of which the initial amount borrowed is repaid.) Within corporate bonds, lower quality issues outperformed, reflecting investors' search for yield.

The fund lagged the comparable composite index over the 12 months, partly as a result of timing differences between the fund's midday pricing and market close at the start and end of the period, but also because there was a larger weighting in UK company shares (equities) than the composite index, at 71%, as these underperformed the sterling bond market. However, the equity segment of the portfolio outperformed the FTSE All-Share Index, largely because of stock selection.

The fund's bond holdings, representing approximately 28% of the portfolio, produced a modest single-digit return, lagging the FTSE UK Conventional Gilts All Stocks Index. This reflected a defensive stance within the fund against a fall in prices, as well as its exposure to corporate bonds.

Within the equity segment, while the fund's sector allocation stance had a neutral effect, at the stock level, value was added across the market capitalisation spectrum, but primarily within the fund's holdings in medium-sized companies. The common denominator was the publication of good results.

Amongst larger companies, the main contributors included software firms Micro Focus International and Sage, drugmakers AstraZeneca and GlaxoSmithKline, Anglo-Australian miner Rio Tinto and water company United Utilities. Micro Focus recovered from a sharp sell-off in the spring of 2018 when the market overreacted to a profit warning related to its purchase of the software arm of Hewlett-Packard – the shares were added to the portfolio on an opportunistic basis after halving in value. AstraZeneca's drugs pipeline has begun to improve,

which is having a positive impact on revenue growth. Rio Tinto benefited from disruptions to production in Brazil and Australia that have pushed up the price of iron ore, contrary to trends elsewhere in commodity markets. United Utilities, along with Pennon and Severn Trent, have been awarded fast-track status on the new 5-year pricing plan by Ofwat, thereby avoiding an extended period of negotiation with the regulator.

Within the fund's medium-sized company holdings, the main sources of added value included emerging market debt fund manager Ashmore, rail and bus operator Go-Ahead, brewer plus pub operator Greene King, and homewares chain Dunelm. Ashmore has experienced continued inflows from its blue-chip client base of governments, central banks, sovereign wealth funds and pension plans despite a weak background for emerging markets and currencies. Go-Ahead, which is an attractive yielder, appears to be putting its troubles behind it as GTR has been delivering an improved operational performance. The company also announced a deal with the Department for Transport to continue the GTR franchise until its 2021 expiry.

Amongst the main individual detractors were bookmaker William Hill, housebuilder Bovis Homes, insurer Aviva, cigarette manufacturers British American Tobacco plus Imperial Brands, and telecoms group Vodafone. Notably, William Hill was adversely affected by the government clampdown on fixed-odds betting terminals. Bovis is recovering from a build quality scandal in 2016/2017, as well as missed production targets; however, the company is well on the way to recovery under a new chief executive. Cigarette manufacturers remain under pressure from the authorities in the US and the UK over their vaping products, added to which there was an adverse court ruling in Canada in a class action earlier this year; nevertheless, yields are attractive and cashflow is strong. Vodafone announced a 40% dividend cut to help meet the cost of servicing debt taken on to assist in the purchase of Liberty Global's cable networks in Germany and Eastern Europe, as well as participating in the 5G spectrum auctions.

Investment activities

The broad thrust of the fund was unchanged over the 12 months under review. Most of the portfolio's weighting remains above index in the more defensive and higher income-earning sectors of the market, while generally avoiding the lower-quality areas. In this regard, there was a preference for adding to holdings or establishing new positions in the resources, telecoms, utilities and financial sectors.

Amongst the new positions established were TP ICAP, a global intermediary firm operating in financial, energy and commodity markets, car insurer Hastings, Paypoint, the point-of-sale payment services provider, Global Ports Holding, the world's largest cruise port operator, St James's Place, the wealth manager, The Restaurant Group which owns Frankie & Benny's, Garfunkel's and Wagamama – the latter, a recent acquisition – and Warehouse REIT (real estate investment trust). The latter formed part of a reorganisation of the fund's exposure to the real estate sector to pick up yield. The common denominator was a solid balance sheet with strong cashflow and an attractive and growing dividend. We also took advantage of the market weakness to add to good dividend payers held in the portfolio on more attractive valuations, including packaging business DS Smith, specialist closed life fund manager Phoenix, telecoms firm BT, oil major BP, along with two utility companies, National Grid and United Utilities.

To help fund these purchases, some holdings were sold as their yields had become less attractive from an income standpoint after a long period of outperformance. These included one smaller company, camera equipment manufacturer Vitec, and several larger companies – alcoholic drinks producer Diageo, speciality chemicals manufacturer Johnson Matthey, water utility Severn Trent and financial services group Old Mutual. The latter was also sold as it had become a rump holding after rebranding and splitting into several smaller companies. In addition, one medium-sized company, paving manufacturer Marshalls, was sold, while another, media group UBM, exited the portfolio after it was taken over by larger rival Informa. Elsewhere, profits were realised in several holdings, including pharmaceutical firms AstraZeneca and GlaxoSmithKline, contract caterer Compass, wealth manager Close Brothers, homewares firm Dunelm and retailer WH Smith.

Finally, in a move towards streamlining its business, technology firm Micro Focus implemented a return of capital and share reduction, following the sale to a Swedish private equity house of its Suse operation. Micro Focus had acquired the open source software specialist last year when it bought another technology company, Attachmate, and sold Suse for more than it paid for the whole Attachmate acquisition.

There was limited trading activity within the fixed income portion of the portfolio, which mainly revolved around recycling the proceeds from maturing bonds back into the market. This was achieved by purchasing bonds on the secondary market and by participating in new bond issues on the primary market that were offered at attractive levels – the latter included issues from Santander, Deutsche Telekom, UNITE,

banking groups BPCE and ING, Ford Motor Credit, Next and Tesco. Meanwhile, this portion of the fund continues to be defensively positioned from a quality perspective, and at a sector level through an emphasis on more defensive areas such as utilities, telecoms and consumer goods.

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, and concerns around Brexit, which is effectively on hold until the Conservative Party finds a new leader and prime minister.

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 low level of bond yields. Another factor, however, has been a remarkably resilient consumer, helped by unemployment at a 44-year low and wage growth that has finally overtaken inflation. In addition, UK equities began 2019 looking relatively cheap as investors reacted to the increased uncertainty over Brexit. Despite this year's rally, though, the UK equity market still represents fair value compared to other equity markets, but it is likely to remain at a discount to them until the Brexit imbroglio has run its course.

Sterling has tended to be more immediately reflective of the Brexit outlook and it is expected to rally strongly if 'no deal' is avoided, but 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.

In this environment, the main strength of the fund's investment portfolio is its broad structure, with its emphasis on equities offering above-average income based on sustainable dividends, together with a substantial weighting in good-quality corporate bonds and a small exposure to government bonds. At current valuation levels, though, the bond portfolio's static contribution to the income stream is below what might be expected over the longer term. However, the bond element continues to provide a degree of stability when equity markets suffer from risk aversion.

Distribution prospects

The fund's income generation has been assisted by the tailwind of sterling weakness on the back of concerns about Brexit and the slowdown in the economy, which has principally benefited the UK's multinationals by boosting the translational effects of their overseas earnings into sterling. The past two years have borne witness to a broadening of the market's dividend-producing base. Despite recent weakness, the recovery in commodity prices from their 2016 lows has enabled the mining behemoths to return to paying dividends once again, and a higher oil price combined with improved production costs has provided greater confidence about the security of future dividend flows from the energy sector. In addition, the UK's banks, another important source of market income in the past, are returning to health and paying dividends again in most cases.

Against this background, underlying dividends (excluding special dividends) in the UK rose 8.7% in 2018. However, the forecast for 2019 is less positive, with dividend growth expected to ease, reflecting greater risks to economic growth. In addition, the magnitude of last year's increases in the mining sector is unlikely to be repeated. Nevertheless, in the absence of unforeseen circumstances, we are aiming for a further increase in the fund's distribution in the 2019/2020 year.

Michael Stiasny

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 31 May	2019	2019	2018 ^[a]
Holding	£'000	%	%
EQUITIES	448,082	76.48	79.53
Software & computer services	9,725	1.66	1.13
290,360 Micro Focus International	5,521	0.94	
565,000 Sage	4,204	0.72	
Telecommunications service providers	24,226	4.14	4.46
3,800,000 BT	7,407	1.27	
3,200,000 KCOM	3,098	0.53	
10,500,000 Vodafone	13,721	2.34	
Pharmaceuticals & biotechnology	37,959	6.48	6.68
325,000 AstraZeneca	18,921	3.23	
1,250,000 GlaxoSmithKline	19,038	3.25	
Banks	32,059	5.47	5.73
380,000 Close Brothers	5,244	0.89	
3,350,000 HSBC	21,658	3.70	
9,000,000 Lloyds Banking	5,157	0.88	
Investment banking & brokerage services	16,364	2.80	1.95
1,000,000 Ashmore	4,720	0.81	
655,821 Brewin Dolphin	2,004	0.34	
396,429 EF Realisation ^[b]	47	0.01	
65,000 Intermediate Capital	853	0.15	
375,000 Jupiter Fund Management	1,374	0.24	
1,630,000 Standard Life Aberdeen	4,360	0.74	
1,100,000 TP ICAP	3,006	0.51	
Equity investment instruments	3,121	0.53	0.49
1,110,000 Ecofin Global Utilities and Infrastructure Trust	1,476	0.25	
1,750,000 Middlefield Canadian Income	1,645	0.28	
Life insurance	34,670	5.92	6.86
2,352,000 Aviva	9,575	1.64	
1,400,000 Chesnara	5,215	0.89	
4,500,000 Legal & General	11,610	1.98	
640,000 Phoenix	4,289	0.73	
150,000 Prudential ^[c]	2,373	0.41	
155,000 St. James's Place	1,608	0.27	
Non-life insurance	6,109	1.05	0.78
1,365,000 Direct Line Insurance	4,316	0.74	
1,000,000 Hastings	1,793	0.31	
Real estate investment & services	3,305	0.57	0.34
2,200,000 Channel Islands Property Fund	2,200	0.38	
1,000,000 Grit Real Estate Income	1,105	0.19	

Portfolio statement (continued)			
as at 31 May	2019	2019	2018 ^[a]
Holding	£'000	%	%
Real estate investment trusts	16,461	2.81	2.75
202,127 British Land	1,075	0.18	
304,687 Land Securities	2,518	0.43	
1,021,809 LondonMetric Property	2,086	0.36	
1,010,000 McKay Securities	2,434	0.42	
425,000 Mucklow A & J	2,720	0.46	
1,663,341 RDI REIT	1,823	0.31	
2,300,000 Standard Life Investment Property Income Trust	2,130	0.36	
1,650,000 Warehouse REIT	1,675	0.29	
Household goods & home construction	7,029	1.20	1.39
105,000 Bellway	2,883	0.49	
425,000 Bovis Homes	4,146	0.71	
Leisure goods	4,462	0.76	0.56
100,000 Games Workshop	4,462	0.76	
Personal goods	12,095	2.05	1.66
250,000 Unilever	12,095	2.05	
Media	22,305	3.80	3.37
1,245,000 Informa	9,644	1.65	
575,000 Moneysupermarket.com	2,098	0.36	
1,573,163 Reach	1,243	0.21	
250,000 RELX	4,605	0.79	
500,000 WPP	4,715	0.79	
Retailers	4,022	0.69	0.64
537,537 DFS Furniture	1,298	0.22	
130,000 Dunelm	1,149	0.20	
80,000 WH Smith	1,575	0.27	
Travel & leisure	22,060	3.77	3.90
100,000 Compass	1,803	0.31	
240,000 Go-Ahead	4,471	0.76	
750,000 Greene King	4,797	0.82	
3,100,000 Marston's	3,339	0.57	
1,300,000 National Express	5,158	0.88	
128,226 Restaurant	172	0.03	
1,750,000 William Hill	2,320	0.40	
Beverages	0	0.00	0.28
Food producers	2,721	0.46	0.64
375,000 Tate & Lyle	2,721	0.46	
Tobacco	23,582	4.03	5.27
500,000 British American Tobacco	13,940	2.38	
500,000 Imperial Brands	9,642	1.65	

Portfolio statement (continued)			
as at 31 May	2019	2019	2018 ^[a]
Holding	£'000	%	%
Construction & materials	1,425	0.24	0.41
500,000 Kier	1,425	0.24	
Electronic & electrical equipment	4,506	0.77	0.91
625,000 discoverIE	2,656	0.45	
750,000 Morgan Advanced Materials	1,850	0.32	
General industrials	2,291	0.39	0.51
731,818 DS Smith	2,291	0.39	
Industrial engineering	816	0.14	1.12
90,000 IMI	816	0.14	
Industrial support services	5,190	0.89	0.92
1,385,000 Connect	530	0.09	
25,000 De La Rue	78	0.01	
300,000 Electrocomponents	1,837	0.32	
250,000 PayPoint	2,745	0.47	
Industrial transportation	589	0.10	0.00
160,920 Global Ports	589	0.10	
Industrial metals & mining	29,437	5.03	4.67
475,000 BHP	8,449	1.44	
465,000 Rio Tinto	20,988	3.59	
Chemicals	3,837	0.65	1.37
300,000 Synthomer	1,096	0.18	
140,000 Victrex	2,741	0.47	
Non-renewable energy	66,175	11.29	11.18
6,350,000 BP	34,118	5.82	
36,791 Lonestar Resources	83	0.01	
1,300,000 Royal Dutch Shell	31,974	5.46	
Electricity	3,757	0.64	0.80
350,000 SSE	3,757	0.64	
Gas, water & multi-utilities	23,813	4.06	4.71
90,855 Centrica	85	0.01	
1,100,000 National Grid	8,650	1.48	
750,000 Pennon	5,502	0.94	
1,200,000 United Utilities	9,576	1.63	
Non-convertible preference shares	23,971	4.09	4.05
1,500,000 Aviva 8.375% Cum. Irrd. Pref.	2,070	0.35	
3,800,000 General Accident 7.875% Cum. Irrd. Pref.	4,826	0.82	
2,000,000 General Accident 8.875% Cum. Irrd. Pref.	2,900	0.49	
7,725,000 Lloyds Banking 9.25% Non-cum. Irrd. Pref.	11,163	1.91	
6,250 Nationwide Building Society 10.25% CCD Non-cum. Irrd. Pref.	924	0.16	
1,600,000 Standard Chartered 8.25% Non-cum. Irrd. Pref.	2,088	0.36	

Portfolio statement (continued)			
as at 31 May	2019	2019	2018 ^[a]
Holding	£'000	%	%
FIXED INCOME			
	141,103	24.10	21.29
'AAA' credit rated bonds			
£1,186,000 Barclays Bank FRN 1.04175% 09/01/2023	1,180	0.20	
£2,121,129 Dukinfield FRN 2.08713% 20/12/2052	2,143	0.37	
£6,030,000 European Investment Bank FRN 1.05375% 17/02/2020	6,040	1.03	
£400,000 Johnson & Johnson 5.5% 06/11/2024	486	0.08	
£2,700,000 KfW 5.55% 07/06/2021	2,952	0.50	
£1,209,077 Paragon Mortgages No. 14 FRN 1.04463% 15/09/2039	1,149	0.20	
£094,258 Residential Mortgage Securities No. 28 FRN 1.99463% 15/06/2046	95	0.02	
£2,343,800 Ripon Mortgages FRN 1.60425% 20/08/2056	2,341	0.40	
£1,742,000 Santander UK FRN 1.03363% 16/11/2022	1,734	0.30	
£1,429,363 Towd Point Mortgage Funding 2016-Auburn 10 FRN 1.82275% 20/04/2045	1,431	0.24	
	21,125	3.61	3.86
'AA' credit rated bonds			
£1,306,000 Land Securities Capital Markets 1.974% 08/02/2024	1,326	0.23	
£2,442,000 Metropolitan Life Global Funding I 1.125% 15/12/2021	2,432	0.42	
£510,000 Metropolitan Life Global Funding I 2.625% 05/12/2022	532	0.09	
£2,500,000 New York Life Global Funding 1% 15/12/2021	2,487	0.42	
£3,000,000 Procter & Gamble 1.375% 03/05/2025	3,010	0.51	
£315,000 SLM Student Loan Trust 2003-10 FRN 1.39263% 15/12/2039	297	0.05	
£1,335,000 Toyota Motor Credit 1.125% 07/09/2021	1,336	0.23	
£1,500,000 UK Treasury 3.75% 07/09/2019	1,512	0.26	
£2,490,000 UK Treasury 4% 07/03/2022	2,726	0.47	
£3,360,000 UK Treasury IL 1.875% 22/11/2022	5,467	0.93	
	45,772	7.82	6.24
'A' credit rated bonds			
£800,000 ABN AMRO Bank 1% 30/06/2020	798	0.14	
£1,100,000 ABN AMRO Bank 1.375% 07/06/2022	1,101	0.19	
£1,750,000 Amgen 5.5% 07/12/2026	2,158	0.37	
£650,000 Anheuser-Busch InBev 9.75% 30/07/2024	897	0.15	
£900,000 Banco Santander 2.75% 12/09/2023	922	0.16	
£2,400,000 Banque Federative du Credit Mutuel 0.875% 08/06/2020	2,390	0.41	
£1,200,000 Banque Federative du Credit Mutuel 1.375% 20/12/2021	1,197	0.20	

Portfolio statement (continued)			
as at 31 May	2019	2019	2018 ^[a]
Holding	£'000	%	%
'A' credit rated bonds (continued)			
£312,000 BASF 1.375% 21/06/2022	315	0.05	
£2,500,000 BMW International Investment FRN 1.1165% 17/07/2019	2,499	0.43	
£2,000,000 BNP Paribas 1.125% 16/08/2022	1,986	0.34	
£3,000,000 BPCE 2.125% 16/12/2022	3,066	0.52	
£1,500,000 Canadian Imperial Bank of Commerce FRN 1.254% 10/01/2022	1,504	0.26	
£2,320,000 Daimler International Finance 1.5% 13/01/2022	2,321	0.40	
£250,000 EDF 6.125% 02/06/2034	355	0.06	
£1,950,000 EDF 6.875% 12/12/2022	2,323	0.40	
£485,000 Experian Finance 2.125% 27/09/2024	494	0.08	
£1,473,000 Heathrow Funding 5.225% 15/02/2023	1,671	0.29	
£2,000,000 HSBC Var. Rate 2.256% 13/11/2026	1,961	0.33	
£421,000 HSBC Holdings Var. Rate 3% 22/07/2028	427	0.07	
£500,000 HSBC Holdings Var. Rate 3% 29/05/2030	501	0.09	
£1,300,000 ING 3% 18/02/2026	1,339	0.23	
£644,000 Lloyds Bank FRN 1.2793% 16/05/2024	645	0.11	
£100,000 London Stock Exchange 9.125% 18/10/2019	103	0.02	
£1,845,000 LVMH Moët Hennessy Louis Vuitton 1% 14/06/2022	1,840	0.31	
£096,000 Motability Operations 6.625% 10/12/2019	99	0.02	
£1,000,000 Munich Re Finance Var. Rate 6.625% 26/05/2042	1,124	0.19	
£918,000 Notting Hill Housing Trust 3.25% 12/10/2048	923	0.16	
£703,000 Total Capital International 1.75% 07/07/2025	715	0.12	
£947,000 UBS 1.25% 10/12/2020	947	0.16	
£1,320,000 United Utilities Water Finance 2% 14/02/2025	1,334	0.23	
£1,043,000 Wells Fargo 1.375% 30/06/2022	1,029	0.18	
£1,950,000 Wells Fargo 5.25% 01/08/2023	2,191	0.37	
£2,530,000 Westfield America Management 2.125% 30/03/2025	2,526	0.43	
£1,750,000 Yorkshire Water Finance 6.5876% 21/02/2023	2,071	0.35	

Portfolio statement (continued)			
as at 31 May	2019	2019	2018 ^[a]
Holding	£'000	%	%
'BBB' credit rated bonds			
£794,000 Akelius Residential Property 2.375% 15/08/2025	32,461	5.54	5.11
£793,000 Annington Funding 2.646% 12/07/2025	781	0.13	
£664,000 Arountown 3% 16/10/2029	790	0.13	
£2,000,000 Aviva Var. Rate 6.625% 03/06/2041	637	0.11	
£1,500,000 Bank of America 5.5% 22/11/2021	2,162	0.37	
£1,000,000 Barclays 3.125% 17/01/2024	1,630	0.28	
£1,026,000 Barclays Var. Rate 2.375% 06/10/2023	1,018	0.17	
£846,000 Channel Link Enterprises Finance Var. Rate 3.043% 30/06/2050	1,017	0.17	
£976,000 Citigroup 2.75% 24/01/2024	862	0.15	
£1,171,000 Credit Suisse Var. Rate 2.125% 12/09/2025	1,003	0.17	
£208,000 Deutsche Telekom 3.125% 06/02/2034	1,152	0.20	
£552,000 Deutsche Telekom International Finance 2.5% 10/10/2025	216	0.04	
£2,180,000 Deutsche Telekom International Finance 7.375% 04/12/2019	569	0.10	
£178,000 Digital Stout 2.75% 19/07/2024	2,244	0.38	
£322,000 Fidelity National Information Services 2.602% 21/05/2025	181	0.03	
£300,000 FirstGroup 6.875% 18/09/2024	327	0.06	
£734,000 Ford Motor Credit 4.535% 06/03/2025	350	0.06	
£3,000 Glencore Canada 7.375% 27/05/2020	761	0.13	
£800,000 Goldman Sachs 3.125% 25/07/2029	3	0.00	
£1,000,000 Goldman Sachs 5.5% 12/10/2021	817	0.14	
£878,000 Imperial Brands Finance 8.125% 15/03/2024	1,083	0.18	
£1,250,000 Imperial Brands Finance 9% 17/02/2022	1,110	0.19	
£357,000 Informa 3.125% 05/07/2026	1,480	0.25	
£1,750,000 InterContinental Hotels 3.875% 28/11/2022	369	0.06	
£426,000 LafargeHolcim Sterling Finance (Netherlands) 3% 12/05/2032	1,875	0.32	
£795,000 Legal & General Var. Rate 10% 23/07/2041	417	0.07	
£454,000 Liberty Living Finance 2.625% 28/11/2024	924	0.16	
£700,000 Lloyds Bank 9.625% 06/04/2023	456	0.08	
£200,000 McDonald's 6.375% 03/02/2020	889	0.15	
£369,000 Mckesson 3.125% 17/02/2029	207	0.04	
£205,000 Next 3% 26/08/2025	377	0.06	
£990,000 Rolls-Royce 3.375% 18/06/2026	209	0.04	
	1,066	0.18	

Portfolio statement (continued)			
as at 31 May	2019	2019	2018 ^[a]
Holding	£'000	%	%
'BBB' credit rated bonds (continued)			
£619,000 Royal Bank of Scotland Var. Rate 3.125% 28/03/2027	621	0.11	
£241,000 Student Finance 2.6663% 30/09/2024	238	0.04	
£1,000,000 Telefónica Emisiones 5.375% 02/02/2026	1,183	0.20	
£422,000 Thames Water Utilities Finance 1.875% 24/01/2024	420	0.07	
£505,000 UNITE 3.5% 15/10/2028	526	0.09	
£2,500,000 Volkswagen Financial Services 1.5% 12/04/2021	2,491	0.43	
'BB' credit rated bonds			
£200,000 Telecom Italia 6.375% 24/06/2019	608	0.10	0.13
£277,000 Tesco 6.125% 24/02/2022	201	0.03	
£101,000 Tesco Corporate Treasury Services 2.5% 02/05/2025	307	0.05	
	100	0.02	
Bonds with no credit rating			
£1,242,000 Coventry Building Society 1% 05/05/2020	21,586	3.69	2.66
£2,000,000 Coventry Building Society 1.875% 24/10/2023	1,238	0.21	
£513,000 DP World 4.25% 25/09/2030	2,015	0.34	
£146,900 Feldspar 2016-1 FRN 1.54463% 15/09/2045	547	0.09	
£793,361 Finsbury Square 2018-1 FRN 1.495% 12/09/2065	147	0.03	
£2,000,000 Hammerson 3.5% 27/10/2025	793	0.14	
£1,536,000 John Lewis 6.125% 21/01/2025	2,048	0.35	
£1,525,000 London Merchant Securities 6.5% 16/03/2026	1,719	0.29	
£1,000,000 National Express 2.5% 11/11/2023	1,936	0.33	
£500,000 Newday Partnership Funding 2017-1 FRN 1.48125% 15/12/2027	1,008	0.17	
£1,997,000 Nordea Eiendomskreditt FRN 1.176% 18/06/2023	494	0.08	
£1,306,749 Oat Hill No. 1 FRN 1.4445% 25/03/2046	1,986	0.34	
£688,000 PCL Funding II FRN 1.48125% 15/06/2022	1,302	0.22	
£572,000 PCL Funding III FRN 1.38125% 15/06/2023	689	0.12	
£1,071,000 Shaftesbury Chinatown 2.348% 30/09/2027	571	0.10	
£463,000 Skipton Building Society 1.75% 30/06/2022	1,059	0.18	
£965,000 Virgin Money FRN 1.4254% 22/03/2024	457	0.08	
£698,000 Virgin Money Holdings Var. Rate 3.375% 24/04/2026	970	0.17	
	694	0.12	

Portfolio statement (continued)			
as at 31 May	2019	2019	2018 ^[a]
Holding	£'000	%	%
Bonds with no credit rating (continued)			
£149,000 Wm Morrison Supermarkets 3.5% 27/07/2026	161	0.03	
£1,500,000 Yorkshire Building Society 3.5% 21/04/2026	1,594	0.27	
£157,000 Yorkshire Building Society Var. Rate 3% 18/04/2025	158	0.03	
Portfolio of investments	589,185	100.58	100.82
CASH EQUIVALENTS	3,593	0.61	0.42
'AAA' rated money market funds ^[d]	3,593	0.61	0.42
3,593,000 Northern Trust Global Fund - Sterling	3,593	0.61	
Total portfolio	592,778	101.19	101.24
Net other assets / (liabilities)	(6,967)	(1.19)	(1.24)
Net assets attributable to shareholders	585,811	100.00	100.00

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

^[a] The comparative sector weightings have been re-analysed to reflect changes to the sector classifications.

^[b] Unquoted / unlisted.

^[c] Related party to the fund.

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

Top ten portfolio transactions	
for the year to 31 May 2019	
Largest purchases	£'000
WPP	3,772
Imperial Brands	3,194
TP ICAP	3,142
BPCE 2.125% 16/12/2022	2,983
Standard Life Aberdeen	2,344
PayPoint	2,333
Brewin Dolphin	2,000
Nordea Eiendomskredditt FRN 1.176% 18/06/2023	1,997
Hastings	1,881
Vodafone	1,826
Other purchases	60,798
Total purchases	86,270
Largest sales	£'000
Vitec	6,733
Prudential ^[a]	4,612
British American Tobacco	3,094
AstraZeneca	3,019
Severn Trent	2,777
GlaxoSmithKline	2,720
Marshalls	2,616
Old Mutual	2,580
Centrica	2,261
Tate & Lyle	2,167
Other sales	67,786
Total sales	100,365

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

^[a] Related party to the fund.

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 (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.

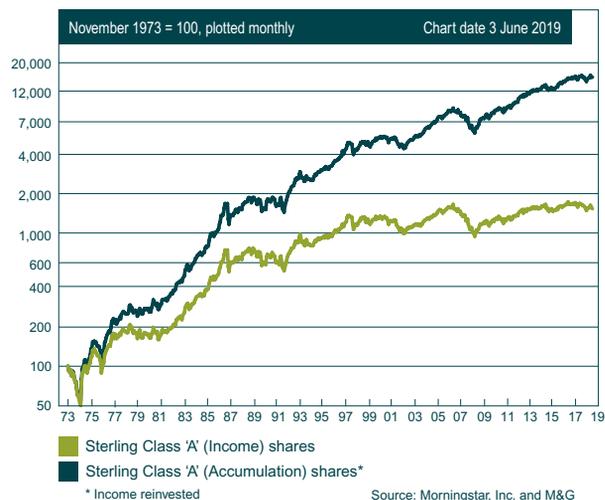
Fund level performance

Fund net asset value

	2019	2018	2017
as at 31 May	£'000	£'000	£'000
Fund net asset value (NAV)	585,811	632,249	673,770

Share class performance since launch

To give an indication of how the fund has performed since launch, the chart below shows performance of Sterling Class 'A' (Accumulation) shares and Sterling Class 'A' (Income) shares. With Accumulation shares, income received from an investment is reinvested, while with Income shares, the income is paid out to shareholders.

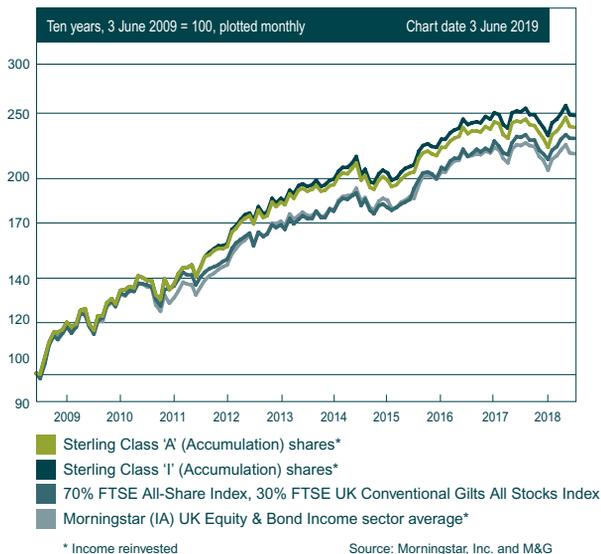


Financial highlights

Fund performance

Ten-year performance

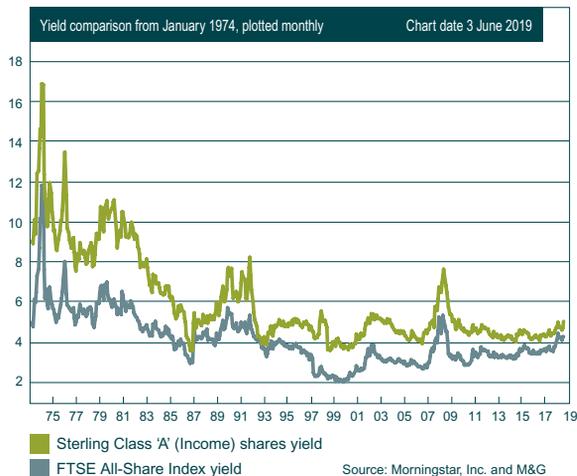
The fund's comparative index changed from the FTSE All-Share Index to a composite index (which comprises 70% FTSE All-Share Index and 30% FTSE UK Conventional Gilts All Stocks Index) in June 2000 to reflect the change in the fund's holdings. Given that we are unable to show the fund's performance against the composite index from inception, please find below a ten-year chart for comparison.



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.

Historic yield

The chart below shows the historic yield of Sterling Class 'A' (Income) shares against that of a comparative index.



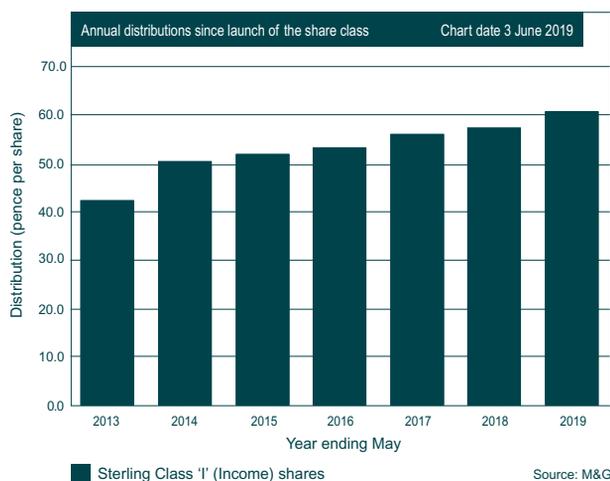
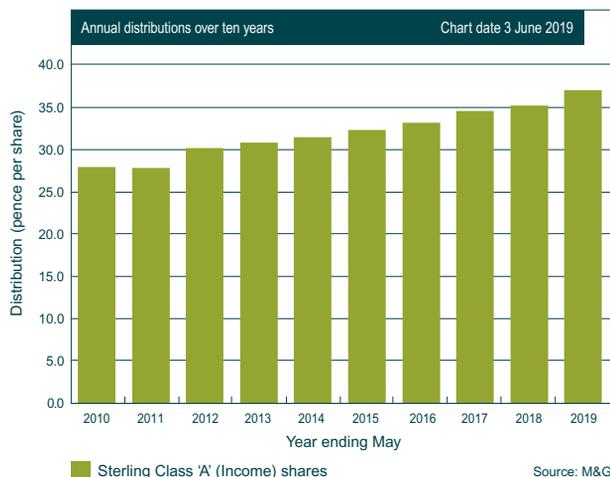
Historic yield: The historic yield reflects distributions declared over the past twelve months as a percentage of the mid-market price, as at the date shown. It does not include any preliminary charge and investors may be subject to tax on their distributions.

Financial highlights

Fund performance

Distribution

The charts below show the annual distribution of Sterling Class 'A' (Income) shares over ten years and Sterling Class 'I' (Income) shares since launch.



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

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

Historic yields for the current year are calculated as at 14 June 2019.

Sterling Class 'A' Accumulation share performance

The share class was launched on 19 November 1973.

for the year to 31 May	2019	2018	2017
Change in NAV per share	UK p	UK p	UK p
Opening NAV	7,300.31	7,131.83	6,071.24
Return before operating charges and after direct portfolio transaction costs	(28.55)	269.04	1,153.37
Operating charges	(102.36)	(100.56)	(92.78)
Return after operating charges	(130.91)	168.48	1,060.59
Distributions	(251.75)	(219.55)	(237.99)
Retained distributions	251.75	219.55	237.99
Closing NAV	7,169.40	7,300.31	7,131.83

Direct portfolio transaction costs	UK p	UK p	UK p
Costs before dilution adjustments	2.24	2.55	15.19
Dilution adjustments ^[a]	(1.05)	(0.78)	(7.10)
Total direct portfolio transaction costs	1.19	1.77	8.09

Performance and charges	%	%	%
Direct portfolio transaction costs ^[b]	0.02	0.03	0.12
Operating charges	1.44	1.42	1.41
Return after operating charges	-1.79	+2.36	+17.47
Historic yield	3.45	3.01	2.95
Effect on yield of charges offset against capital	0.01	0.01	0.01

Other information

Closing NAV (£'000)	20,174	22,610	26,032
Closing NAV percentage of total fund NAV (%)	3.44	3.58	3.86
Number of shares	281,385	309,708	365,011
Highest share price (UK p)	7,403.78	7,397.19	7,128.93
Lowest share price (UK p)	6,582.75	6,747.37	5,860.75

Financial highlights

Fund performance

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	1,663.07	1,614.52	1,367.12
Return before operating charges and after direct portfolio transaction costs	(6.69)	60.96	259.88
Operating charges	(12.88)	(12.41)	(12.48)
Return after operating charges	(19.57)	48.55	247.40
Distributions	(67.69)	(59.97)	(59.22)
Retained distributions	67.69	59.97	59.22
Closing NAV	1,643.50	1,663.07	1,614.52

Direct portfolio transaction costs	UK p	UK p	UK p
Costs before dilution adjustments	0.51	0.58	3.44
Dilution adjustments ^[a]	(0.24)	(0.18)	(1.61)
Total direct portfolio transaction costs	0.27	0.40	1.83

Performance and charges	%	%	%
Direct portfolio transaction costs ^[b]	0.02	0.03	0.12
Operating charges	0.79	0.77	0.84*
Return after operating charges	-1.18	+3.01	+18.10
Historic yield	4.04	3.60	3.43
Effect on yield of charges offset against capital	0.01	0.01	0.09

Other information

Closing NAV (£'000)	35,417	32,754	26,341
Closing NAV percentage of total fund NAV (%)	6.05	5.18	3.91
Number of shares	2,154,969	1,969,502	1,631,525
Highest share price (UK p)	1,696.15	1,684.84	1,613.89
Lowest share price (UK p)	1,505.00	1,535.26	1,319.92

* As the annual management charge had been discounted during the period 0.76% is more reliable estimate of the operating charges for the period to 31.05.17.

^[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.

Financial highlights

Operating charges and portfolio transaction costs

Portfolio transaction costs

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

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

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

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

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

Portfolio transaction costs				
for the year to 31 May	2019	2018	2017	Average ^[a]
Direct portfolio transaction costs ^[b]	%	%	%	%
Broker commission	0.01	0.01	0.00	0.01
Taxes	0.02	0.03	0.23	0.09
Costs before dilution adjustments	0.03	0.04	0.23	0.10
Dilution adjustments ^[c]	(0.01)	(0.01)	(0.11)	(0.04)
Total direct portfolio transaction costs	0.02	0.03	0.12	0.06
as at 31 May	2019	2018	2017	Average ^[a]
Indirect portfolio transaction costs	%	%	%	%
Average portfolio dealing spread	0.26	0.26	0.26	0.26

^[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



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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