M&G Optimal Income Fund

Interim Short Report March 2019
For the six months ended 31 March 2019

M&G INVESTMENTS

Fund information

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

ACD

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

Important information

Following the successful extraordinary resolution at the shareholder meeting held on 4 October 2018, the non-sterling share classes of the M&G Optimal Income Fund merged into the M&G (Lux) Optimal Income Fund (a sub-fund of M&G (Lux) Investment Funds 1) on 8 March 2019.

Please note that on 18 January 2019, the Sterling Class 'J' shares launched.

For further details of the mergers, please refer to www.mandg.com/brexitmergerdocumentation.

Investment objective

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

Investment policy

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

Investment approach

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

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

Fund information

Risk profile

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

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

The fund's exposure to fixed income securities may be gained through the use of derivatives. In association with the use of derivatives, including those instruments not traded through an exchange, collateral is deposited in order to mitigate the risk that a counterparty may default on its obligations or become insolvent.

Portfolio diversification is key in managing liquidity and default risks as well as reducing market risk. The fund's risks are measured and managed as an integral part of the investment process.

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

Low risk ⟵⟶ High risk

Typically lower rewards ⟵⟶ Typically higher rewards

1	2	**3**	4	5	6	7

The above number:

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

Investment review

As at 1 April 2019, for the six months ended 31 March 2019

Performance against objective

Between 1 October 2018 (the start of the review period) and 1 April 2019, the M&G Optimal Income Fund delivered a small positive total return (the combination of income and growth of capital) across all of its sterling class shares.

On 8 March 2019, the fund's non-sterling share classes merged into the M&G (Lux) Optimal Income Fund, a Luxembourg-authorised SICAV which launched on 5 September 2018. The M&G Optimal Income Fund's euro and Swiss franc shares produced broadly flat returns between 1 October 2018 and 8 March 2019, while its Singapore and US dollar share classes delivered positive returns over the same period*.

The fund's holdings are split between high-quality, or investment grade, corporate bonds, high-yielding corporate bonds and government bonds, which typically provide liquidity and stability in uncertain markets.

Bonds are loans that are extended by an investor to an issuing entity – such as a company or government – in exchange for regular interest payments. The initial amount borrowed by the entity is usually repaid at the end of the loan's life. Bonds issued by companies are referred to as 'corporate bonds', while those issued by governments are called 'government bonds'. Investment grade corporate bonds refer to debt securities issued by a company with a medium or high credit rating from a recognised credit rating agency. They are considered to be at lower risk of non-repayment than those issued by companies with lower credit ratings (known as high yield bonds). The performance of investment grade corporate bond markets can be influenced by the performance of government bonds.

* For the performance of each share class, please refer to the 'Long-term performance by share class' table in the 'Fund performance' section of the Interim Long Report and unaudited Financial Statements for M&G Optimal Income Fund.

Investment review

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

Long-term performance [a]

	From 01.10.18 % [b]	From 01.04.16 % p.a.	From 01.04.14 % p.a.	Since launch % p.a.
Sterling [c]				
Class 'A'	+1.0	+3.8	+2.8	+6.2 [d]
Class 'I'	+1.2	+4.3	+3.2	+6.7 [d]

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

[b] Absolute basis.

[c] Price to price with income reinvested.

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

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

Investment performance

Volatility returned to financial markets in 2018, as a result of a range of factors that included higher interest rates and inflation, political uncertainty and global trade tensions.

The US Federal Reserve (Fed) raised interest rates in December, making it a total of nine times US rates have risen since the great financial crisis about a decade ago. In the UK, much uncertainty remained about the eventual terms of the country's Brexit deal with the European Union (EU). This contributed to periods of adverse sentiment towards UK bonds. Investors in Europe became concerned in the latter stages of 2018 about Italian proposals to increase the country's budget deficit. The plans, which met with opposition from the EU, were drafted after an anti-establishment party gained a strong presence in Italy's new coalition government.

Investor sentiment towards corporate bonds – and international stockmarkets – was increasingly affected by concerns of a trade war developing between the US and China. In addition, during the latter months of 2018, global economic growth forecasts began to moderate, which contributed to some weaker confidence in the outlook for corporate bonds and emerging markets.

The mood then changed once again in early 2019, as investors took comfort from the Fed's statements that the central bank would moderate its strategy of raising interest rates. This resulted in a strong start to the year for corporate bonds – and took corporate bond returns for the six-month period back into positive territory.

At the very end of the reporting period, the UK's exit from the EU was delayed. This did not have a significant impact on sterling-denominated investment grade corporate bonds, which delivered positive returns over the six-month period, as did those denominated in euros and US dollars. Government bonds also generally delivered positive returns.

In these circumstances, the fund's performance was driven by its significant exposure to investment grade corporate bonds, and in particular, by its sizeable allocation to the US dollar-denominated segment of the market. After a strong start to 2019 for stockmarkets, the fund's small allocation to equities (company shares) also helped returns. However, its relative lack of sensitivity to changes in interest rates (known as duration) constrained relative performance, as the overall direction of government bond yields over the six months was downwards.

Investment activities

We adjust the fund's positioning to reflect changes in our outlook regarding interest rates, credit risk and changes in relative value among the different fixed income asset classes. Throughout the review period, we continued to find most value in investment grade corporate bonds and, as a result, held proportionately more of these than bonds issued by governments or riskier, so-called 'high yield', companies.

Within investment grade corporate bonds, we were active in the primary market, where we were able to buy bonds that came with an attractive new issue premium, as well as in the secondary market, where we undertook a number of relative value trades. For example, in January we sold bonds from telecoms firm Orange that were denominated in sterling, to buy bonds from the same company issued in euros.

We can invest a portion of the fund (up to 20%) in equities if we believe a company's shares present a more attractive investment opportunity relative to its bonds. We did not make any material changes to our equity exposure, which ended the review period at around 4.7%.

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

Outlook

The biggest story in financial markets in recent months continues to be the likelihood of the US economy entering recession. The market is pricing in imminent recession, while a range of leading economic indicators point to the next recession being several years away. The labour market remains very strong, which is expected to push wages higher in time. The US is a service-based economy, and its reliance on people rather than goods means that it is unlikely to turn deflationary in the short to medium term. The market now expects the US Federal Reserve's next move will be to cut rather than increase interest rates, but in our view, the Fed risks falling further behind the curve.

While the UK is at a different stage in the cycle to the US from a monetary policy perspective due to Brexit, the two are in a similar place from an economic standpoint.

Against this backdrop, corporate bond valuations remain attractive and we are being paid to take risk. We prefer corporate bonds to government bonds for a variety of reasons. One is supply – we anticipate a significant shift in supply dynamics going forward. Treasury issuance is set to rise considerably as the US budget deficit swells under President Trump, while the recent era of merger & acquisition activity that has been funded by companies issuing substantial amounts of debt is coming to an end.

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

Richard Woolnough
Fund manager

An employee of M&G Limited which is an associate of M&G Securities Limited.

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

Classification spread of investments

The table below shows the percentage holding per sector.

	% of fund as at 31.03.19	30.09.18
EQUITIES		
Telecommunication service providers	0.13	0.25
Pharmaceuticals & biotechnology	0.00	0.59
Banks	2.07	1.70 [a]
Non-life insurance	0.31	0.53
Automobiles & parts	0.75	0.80
Travel & leisure	0.24	0.04
Tobacco	0.55	0.37
Industrial support services	0.24	0.05
Industrial metals & mining	0.00	0.00
Chemicals	0.19	0.00
Non-renewable energy	0.01	0.02
Electricity	0.29	0.20
FIXED INCOME		
Debt securities		
'AAA' credit rated bonds	16.57	12.69
'AA' credit rated bonds	5.40	20.43
'A' credit rated bonds	10.40	8.05
'BBB' credit rated bonds	45.87	36.69
'BB' credit rated bonds	9.41	9.06
'B' credit rated bonds	1.27	1.42
'CCC' credit rated bonds	0.05	0.10
Bonds with no credit rating	2.81	3.64
Debt derivatives		
Credit default swaps	(0.02)	0.05
Interest rate swaps	0.00	0.19
Interest rate futures	(1.23)	0.51
CURRENCY		
Forward currency contracts	1.05	0.24
CASH EQUIVALENTS		
'AAA' rated money market funds [b]	2.32	1.21
SHARE CLASS HEDGING		
Forward currency contracts for share class hedging	0.00	(0.45)

[a] Restated.

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

Portfolio transactions

for the six months to 31 March Portfolio transactions	2019 £'000	2018 £'000
Total purchases	5,312,809	7,706,265
Total sales	24,135,537	4,553,759

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

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

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

We show performance for these two share classes because:

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

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

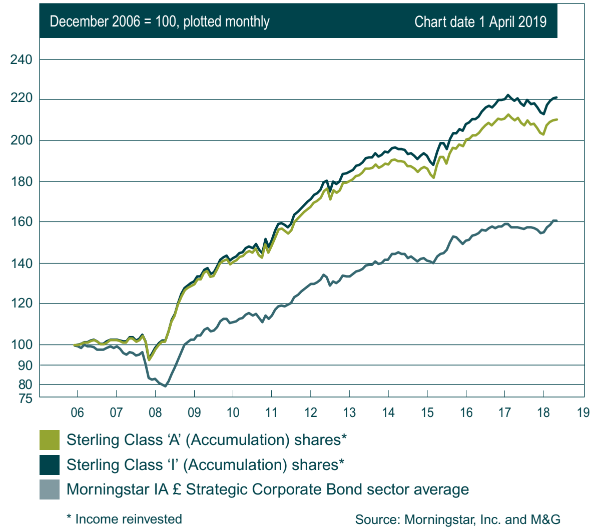
Fund level performance

Fund net asset value

as at	31.03.19 £'000	30.09.18 £'000	30.09.17 £'000
Fund net asset value (NAV)	3,638,074	23,097,567	20,637,023

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.



Financial highlights

Fund performance

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

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

Sterling Class 'A' Accumulation share performance

The share class was launched on 8 December 2006.

Change in NAV per share	Six months to 31.03.19 UK p	Year to 30.09.18 UK p	Year to 30.09.17 UK p
Opening NAV	208.93	208.53	196.82
Return before operating charges and after direct portfolio transaction costs	3.07	3.35	14.56
Operating charges	(1.46)	(2.95)	(2.85)
Return after operating charges	1.61	0.40	11.71
Distributions	(2.05)	(3.09)	(3.89)
Retained distributions	2.05	3.09	3.89
Closing NAV	210.54	208.93	208.53
Direct portfolio transaction costs	**UK p**	**UK p**	**UK p**
Costs before dilution adjustments	0.01	0.03	0.01
Dilution adjustments [a]	0.00	0.00	0.00
Total direct portfolio transaction costs	0.01	0.03	0.01
Performance and charges	**%**	**%**	**%**
Direct portfolio transaction costs [b]	0.01	0.02	0.01
Operating charges	1.41	1.41	1.40
Return after operating charges	+0.77	+0.19	+5.95
Distribution yield	1.48	1.81	1.26
Effect on yield of charges offset against capital	0.00	0.00	0.00
Other information			
Closing NAV (£'000)	433,369	518,684	567,587
Closing NAV percentage of total fund NAV (%)	11.91	2.25	2.75
Number of shares	205,835,191	248,252,722	272,182,254
Highest share price (UK p)	211.12	213.47	209.59
Lowest share price (UK p)	202.98	206.80	195.86

Sterling Class 'I' Accumulation share performance

The share class was launched on 8 December 2006.

Change in NAV per share	Six months to 31.03.19 UK p	Year to 30.09.18 UK p	Year to 30.09.17 UK p
Opening NAV	218.96	217.46	204.22
Return before operating charges and after direct portfolio transaction costs	3.23	3.49	15.15
Operating charges	(0.99)	(1.99)	(1.91)
Return after operating charges	2.24	1.50	13.24
Distributions	(2.68)	(4.33)	(5.09)
Retained distributions	2.68	4.33	5.09
Closing NAV	221.20	218.96	217.46
Direct portfolio transaction costs	**UK p**	**UK p**	**UK p**
Costs before dilution adjustments	0.01	0.03	0.01
Dilution adjustments [a]	0.00	0.00	0.00
Total direct portfolio transaction costs	0.01	0.03	0.01
Performance and charges	**%**	**%**	**%**
Direct portfolio transaction costs [b]	0.01	0.02	0.01
Operating charges	0.91	0.91	0.91
Return after operating charges	+1.02	+0.69	+6.48
Distribution yield	1.98	2.31	1.76
Effect on yield of charges offset against capital	0.00	0.00	0.00
Other information			
Closing NAV (£'000)	1,513,468	1,527,682	1,448,476
Closing NAV percentage of total fund NAV (%)	41.60	6.61	7.02
Number of shares	684,212,470	697,689,230	666,103,023
Highest share price (UK p)	221.78	222.98	218.55
Lowest share price (UK p)	212.98	216.46	203.38

[a] In respect of direct portfolio transaction costs.

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

Financial highlights

Operating charges and portfolio transaction costs

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

Operating charges

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

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

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

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

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

Portfolio transaction costs

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

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

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

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

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

Portfolio transaction costs

Direct portfolio transaction costs [b]	Six months to 31.03.19 %	Year to 30.09.18 %	Year to 30.09.17 %	Average [a] %
Broker commission	0.01	0.01	0.01	0.01
Taxes	0.00	0.01	0.00	0.00
Costs before dilution adjustments	0.01	0.02	0.01	0.01
Dilution adjustments [c]	0.00	0.00	0.00	0.00
Total direct portfolio transaction costs	0.01	0.02	0.01	0.01
as at Indirect portfolio transaction costs	**31.03.19 %**	**30.09.18 %**	**30.09.17 %**	**Average [a] %**
Average portfolio dealing spread	0.64	0.48	0.56	0.56

[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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