M&G Recovery Fund

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

Interim Short Report December 2018
For the six months ended 31 December 2018

Fund information

The Authorised Corporate Director (ACD) of M&G Investment Funds (3) presents its Interim 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 Interim Long Report and unaudited 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 28 September 2018, the Depositary changed from National Westminster Bank Plc, to NatWest Trustee & Depositary Services Limited.

Fund manager's introduction

Dear Shareholder

There is no escaping the fact that an increasingly weak market backdrop in 2018, both at home and abroad, did not suit the M&G Recovery Fund's portfolio 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 six months has been disappointing in performance terms for most market participants, but the fund has been particularly vulnerable. However, I should like to emphasise the short-term nature of current events and, despite this setback, which reflects the fund's differentiated positioning relative to the market, my faith in the proposition and the underlying value of the portfolio.

One specific factor behind the fund's recent underperformance has been its lower exposure to larger companies than the UK market. As a group, larger companies outperformed in the second half of 2018, mostly because of their international exposure as this helped to shield them from a domestic market increasingly absorbed by Brexit. Medium-sized and smaller companies, where the fund is primarily concentrated, were unable to escape the maelstrom at home. Over the long term, however, our recovery companies are the acorns that should grow into beautiful oak trees.

Another factor recently has been a weak performance from the fund's holdings in biotechnology firms and raw material companies such as miners and oil producers. I gave a couple examples of the former in my letter accompanying the Annual report in July. These firms are testing the frontiers of research and development into ground-breaking and life-saving medicines. By their nature, there are advances and setbacks, but overall I am very pleased with the progress they are making. Resource companies have been affected by falling prices of raw materials, amidst concerns about slowing global economic growth led by China. However, although some of the miners and oil companies held in the fund have had their share prices driven down by broader market trends, their individual merits, which justified the original investment case, have not changed and I would expect the fundamentals to reassert themselves once the market volatility has subsided.

Fund information

Nearly 90% of the fund is typically invested in UK stocks, although around 76% of their revenues are earned outside the UK, which the market has ignored, and part of the performance issue has been that the UK stockmarket is unloved by investors at the moment. Indeed, it was one of the worst performers of the major regional markets over the past six months. The UK is normally perceived to possess some defensive attributes, such as attractive dividend payers, world-beating companies, plus a strong legal and corporate governance culture. But overseas and domestic investors have eschewed the UK as facing too much uncertainty. This has also had a dampening effect recently on mergers and acquisitions (M&A), after picking up earlier in 2018. M&A activity can be a significant performance driver as fund holdings on the mend, which is yet to be recognised in their share price, make attractive opportunities for acquisitive companies. Unusually, therefore, there was only one bid for a portfolio holding in the whole of 2018 and that was IWG, a serviced office supplier. However, although there were five predators stalking it, ultimately, and with our support for the board, they walked away without the prize because they were not willing to pay enough. While we do not invest in companies in the hope that they will be bought, once the current uncertainty has cleared, the UK is an attractively valued market with some top-quality businesses, and combined with a weak pound, it is likely to prove irresistible to overseas buyers.

We are not big traders on the fund and generally the turnover is relatively low at around 20% of the portfolio per annum. I would like to draw your attention, though, to one new company we supported towards the year end, and that was Kier, a construction firm involved in infrastructure projects in the UK for the government, NHS and local authorities. Kier needed at short notice to improve its balance sheet or it would have been excluded from bidding for government contracts in 2019 and the banks would not extend it any further credit, so it had to raise cash in the market by means of a rights issue. Unfortunately for Kier, the share price collapsed and the rights issue failed, which meant that a perfectly good company with 20,000 employees could have gone into receivership, and just before Christmas. We helped provide the finance to prevent this happening, and as a result, have ended up with a significant stake in the business. Encouragingly, at the time of writing, the share price has staged a very decent recovery. You can read about more of the fund's activities in the interim report.

On that more cheerful note, I should like to conclude by reaffirming my view that there is substantial latent value in the fund and we continue to see encouraging operational progress at the businesses the fund owns. I do not believe the fund has a particular exposure to Brexit, above and beyond being invested in UK-listed companies, and would emphasise that recent setbacks have provided an opportunity to pick up stock at more attractive levels.

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

Yours sincerely

Tom Dobell
Fund manager

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

Investment objective and policy

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

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.

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.

As at 2 January 2019, for the six months ended 31 December 2018

Performance against objective

The M&G Recovery Fund aims to deliver capital growth by investing at least 80% of the portfolio in the shares of UK-listed 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 missed this objective, as it produced a negative total return (the combination of income and growth of capital) across all share classes between 2 July 2018 (the start of the review period) and 2 January 2019.*

The fund's returns in all share classes were behind that of a comparative index, the FTSE All-Share Index. Over the same period, returns for the index were -9.8% and -11.5% in sterling and euro terms, respectively.

* 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 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

	Six months 02.07.18 % [a]	Three years 04.01.16 % p.a.	Five years 02.01.14 % p.a.	Since launch % p.a.
Sterling [b]				
Class 'A'	-16.5	+4.3	-0.9	+13.3 [c]
Class 'I'	-16.2	+5.1	-0.2	+3.4 [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 six-month review period and underperformed its comparative index, the FTSE All-Share Index. This was due to the adverse market conditions and the fund's differentiated positioning relative to the market. In addition, the fund's 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 six months has been disappointing in performance terms for most market participants, 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.

The six months under review was a volatile period for UK equities, or company shares, as sentiment was undermined by a toxic combination of central banks raising interest rates, led by the US Federal Reserve, the withdrawal of the stimulus packages that have supported markets over the past decade, the impact of President Trump's trade war on China and concerns about the US economy, just as the effect of the tax boost is beginning to wane. US protectionism also affected the other big exporting economies of Europe, Japan and Asia. Another market driver was a strengthening US dollar, which undermined emerging economies with large dollar debts. In addition, slowing global demand resulted in a sharp fall in the price of raw materials, which left Brent crude at slightly over USD50 per barrel by the year end, a decline of 41% from its USD86 high in early October.

In the UK, Brexit increasingly monopolised the headlines, with the odds shortening on a bad outcome and the possibility of a general election. Although the European Union (EU) approved Theresa May's withdrawal agreement, the prime minister postponed the Common's vote on the deal until mid-January, as it quickly became apparent that she would not secure a majority, despite surviving a leadership challenge. The main sticking point seemed to be the lack of a time limit given to the backstop arrangement if an agreement cannot be reached in time on the Irish border issue. (On January 15, Parliament voted against the deal by a large majority.)

Sterling had a choppy ride over the period, after rising above USD1.40 at the start of the year for the first time following its Brexit-related devaluation. Since April, however, the currency has come under pressure due to increasing concerns about Brexit and some weaker economic data in the UK as the consumer and the corporate sector have delayed spending decisions until after March 2019. Sterling weakness also partly reflected a resurgent US dollar. The currency trend helped support the larger, internationally exposed companies in the UK stockmarket as it boosted their overseas earnings when they were translated into sterling. Medium-sized and smaller companies underperformed, as they tend to have more domestic exposure, and investors fretted about the impact of Brexit on the UK economy.

At a sector level, with few places to hide, investors sought out the more defensive areas of the market, such as consumer staples companies, pharmaceutical manufacturers, fixed line telecoms firms and the water utilities. In addition, media companies were supported by bid activity.

Amongst the fund's top contributors to performance over the six-month period were gold miner St Barbara and Ei Group (formerly Enterprise Inns), which benefited from investors' risk aversion, and additionally in the case of the latter, from the announcement that it intended to sell some of its property portfolio. FTSE 100 banking group HSBC Holdings was supported by its overseas focus, while a position in telecoms firm BT Group attracted some bargain hunting after a weak first half to 2018. Elsewhere, shares in MC Mining, which produces high-quality coking and thermal coal, rose strongly after it was granted some mining rights for a South African project after a five-year wait; and holdings in industrial thread manufacturer Coats Group, along with Indian electricity generator OPG Power Ventures, were supported by decent results. In the media sector, the fund's sixth-largest holding, Entertainment One, continued to add value. The company is delivering on growth expectations for its franchises, Peppa Pig and MGC, and is seeing increasing success in its television content division. In addition, sector allocation made a modest contribution, principally through avoiding tobacco stocks in the portfolio, which sold off sharply in 2018.

Conversely, the majority of the underperformance was down to a below-market exposure to larger companies and stock selection. In particular in the latter case, in the biotech sector, GW Pharmaceuticals and Oxford Biomedica experienced profit-taking, while Hutchison China Meditech and Mesoblast were affected by what the market perceived to be disappointing drug trial data, although we felt this was substantially overdone. Nevertheless, it has been encouraging to see the progress these companies have been making in developing their drug pipelines and moving towards commercialisation.

Elsewhere, some of the fund's resource company holdings (First Quantum Minerals, Bacanora Lithium, Tullow Oil and Nostrum Oil & Gas) were affected by weakening demand for raw materials and the fall in the oil price.

Investment activities

During the review period, we established three new positions on the fund: construction firm Kier Group, oil services supplier Petrofac, and corporate broking firm plus wealth manager WH Ireland.

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 a rights issue by the company to earn some extra income for the fund. For the first time in a decade in the UK market, Kier's rights issue failed as the share price collapsed below the rights 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. This was a good opportunity for the fund to invest in a company with a reinforced balance sheet at an attractive valuation in an area of the market where rivals have struggled to compete.

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 the 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 wrong-doing (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 the AIM (the 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, which has a private client book worth approximately £1 billion and includes eight regional offices in the UK and the Isle of Man, together with a large cash balance for its size, are worth more than its market capitalisation (the number of WH Ireland shares in issue multiplied by the share price).

We also participated in a number of refinancings of existing holdings during the six months, 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.

We made three complete sales over the period to provide funds for better opportunities. These included two stage 1 (unloved) companies, Dixons Carphone and African Petroleum, which 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 previously; but the share price has been lacklustre recently. The other complete sale was UDG Healthcare, a provider of medical equipment and healthcare services to the pharmaceutical sector. The shares had enjoyed a significant run-up and the company had reached stage 3 (recovering well) of our recovery process.

Elsewhere, we realised some profits in other stage 3 holdings such as biotechnology firm GW Pharmaceuticals, emergency repairs business HomeServe, media group Entertainment One, cruise line operator Carnival and industrial thread manufacturer Coats. The proceeds were recycled into some of our more recently acquired stage 1 holdings, including outsourcer Capita, African gold miner Hummingbird Resources and Micro Focus International. The technology firm was introduced in the first half of 2018 after the share price halved following a profit warning. 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.

Outlook

Although there are signs of caution appearing in the UK stockmarket, reflected in a tapering off in merger and acquisition activity, and there is talk of a fourth-quarter contraction by the economy, as manufacturing surveys have turned downward amidst softening business sentiment, the latest corporate earnings and dividend announcements have been broadly supportive. However, until greater clarity appears over the many possible Brexit outcomes, the domestic market is unlikely to make much progress. There is also the short-term negative impact of a weakening oil price on the energy sector, acting as a headwind for the market. In the medium-to-longer term, though, cheaper fuel costs are akin to a tax cut for manufacturers and consumers. Meanwhile, UK interest rates remain ultra-low and labour market dynamics should provide an important support to consumer confidence, as recent data from the retail, housing and auto sectors have not been encouraging.

The UK is home to some fantastic companies operating within a strong corporate governance and legal framework. We continue to believe in taking a contrarian view on the fund, ignoring the short-term noise and exploiting mispriced risk to invest in some great opportunities.

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.

Investment review

Portfolio statement

as at Holding		31.12.18 £'000	31.12.18 %	30.06.18 %
	EQUITIES	**2,161,991**	**100.09**	**100.19**
	Oil & gas producers	**287,625**	**13.31**	**13.70**
39,910,000	BP	198,971	9.21	
16,592,508	Great Eastern Energy GDR	11,615	0.54	
8,970,675	Nostrum Oil & Gas	9,347	0.43	
87,688,530	Providence Resources [a]	10,172	0.47	
32,170,000	Tullow Oil	57,520	2.66	
	Oil equipment, services & distribution	**17,206**	**0.79**	**0.43**
12,600,000	Lamprell	7,610	0.35	
2,005,000	Petrofac	9,596	0.44	
	Industrial metals & mining	**57,212**	**2.65**	**3.46**
103,636,364	Bluejay Mining [a]	13,628	0.63	
7,063,300	First Quantum Minerals	43,584	2.02	
	Mining	**172,536**	**7.99**	**7.29**
13,456,784	Bacanora Lithium [a]	3,230	0.15	
11,197,353	Hummingbird Resources [a]	2,363	0.11	
17,855,335	Kenmare Resources	33,032	1.53	
40,788	Kenmare Resources wts. 2019	0	0.00	
23,346,347	MC Mining [a]	12,140	0.56	
50,128,263	Petra Diamonds	18,798	0.87	
1,365,000	Rio Tinto	51,385	2.38	
17,340,000	St Barbara	44,188	2.05	
28,247,500	Sylvania Platinum [a]	4,520	0.21	
77,751,220	White Energy Company	2,880	0.13	
	Construction & materials	**108,684**	**5.03**	**4.21**
13,165,000	Balfour Beatty	32,676	1.51	
2,691,000	CRH	55,462	2.57	
5,048,239	Kier Group	20,546	0.95	
	Aerospace & defence	**53,616**	**2.48**	**2.46**
19,800,000	Cobham	19,460	0.90	
2,670,000	Meggitt	12,522	0.58	
4,350,000	QinetiQ Group	12,515	0.58	
1,100,000	Rolls-Royce Holdings	9,119	0.42	
	General industrials	**54,650**	**2.53**	**2.99**
45,000,000	Coats Group	36,720	1.70	
1,315,000	Smiths Group	17,930	0.83	
	Electronic & electrical equipment	**7,050**	**0.33**	**0.41**
5,000,000	Xaar	7,050	0.33	
	Industrial engineering	**41,302**	**1.91**	**1.77**
27,500,000	Renold	7,700	0.36	
36,400,000	Severfield	25,116	1.16	
146,309,150	TP Group [a]	8,486	0.39	

Portfolio statement (continued)

as at Holding		31.12.18 £'000	31.12.18 %	30.06.18 %
	Industrial transportation	**42,922**	**1.99**	**1.67**
5,812,903	Avation	14,823	0.69	
346,934,550	Mercantile Ports [a]	8,326	0.38	
13,846,267	Stobart Group	19,773	0.92	
	Support services	**124,232**	**5.75**	**6.41**
27,250,000	Capita	30,316	1.40	
3,831,192	Essentra	13,141	0.61	
1,680,000	Grafton Group	10,819	0.50	
3,000,000	HomeServe	25,890	1.20	
21,298,236	IWG	44,066	2.04	
	Food producers	**38,081**	**1.76**	**1.57**
7,287,630	REA Holdings	17,199	0.80	
2,380,000	Tate & Lyle	15,789	0.73	
46,304,408	Zambeef Products [a]	5,093	0.23	
	Household goods & home construction	**11,520**	**0.53**	**0.29**
8,240,000	McCarthy & Stone	11,520	0.53	
	Healthcare equipment & services	**0**	**0.00**	**0.28**
	Pharmaceuticals & biotechnology	**272,480**	**12.61**	**13.57**
5,356,802	Eco Animal Health [a]	21,427	0.99	
1,252,900	GW Pharmaceuticals ADR	93,546	4.33	
2,340,838	Hutchison China Meditech ADR	42,424	1.96	
54,497,775	Mesoblast	34,795	1.61	
1,038,939	Mesoblast ADR	3,173	0.15	
11,156,679	Oxford Biomedica	77,115	3.57	
	General retailers	**35,391**	**1.64**	**2.27**
1,200,000	Dignity	8,250	0.38	
53,038,237	Mothercare	8,327	0.39	
18,265,757	Saga	18,814	0.87	
	Media	**82,306**	**3.81**	**3.95**
13,489,394	Entertainment One	47,267	2.19	
11,850,000	ITV	14,777	0.68	
2,175,000	Pearson	20,262	0.94	
	Travel & leisure	**176,198**	**8.16**	**8.97**
341,502	Carnival	12,772	0.59	
5,625,000	Dalata Hotel Group	23,963	1.11	
3,142,000	easyJet	35,049	1.62	
33,300,000	Ei Group	60,872	2.82	
745,331,981	fastjet	10,062	0.47	
9,321,340	fastjet wts. 2021	0	0.00	
9,000,000	National Express	33,480	1.55	

Portfolio statement (continued)

as at Holding		31.12.18 £'000	31.12.18 %	30.06.18 %
	Fixed line telecommunications	**42,705**	**1.98**	**1.30**
18,000,000	BT Group	42,705	1.98	
	Mobile telecommunications	**616**	**0.03**	**0.04**
27,359,073	Avanti Communications [a]	616	0.03	
	Electricity	**10,552**	**0.49**	**0.31**
34,149,791	KSK Power Ventur [b]	0	0.00	
49,079,566	OPG Power Ventures [a]	10,552	0.49	
	Banks	**340,812**	**15.78**	**14.38**
29,700,000	HSBC Holdings	191,595	8.87	
132,480,000	Lloyds Banking Group	68,346	3.17	
17,700,000	Royal Bank of Scotland Group	38,037	1.76	
7,030,000	Standard Chartered	42,834	1.98	
	Life insurance	**87,647**	**4.06**	**5.16**
9,350,000	Aviva	35,072	1.62	
3,750,000	Prudential [c]	52,575	2.44	
	Financial services	**29,512**	**1.37**	**1.19**
17,657,142	IP Group	18,893	0.87	
2,550,000	TP Icap	7,678	0.36	
4,525,079	WH Ireland [a]	2,941	0.14	
	Equity investment instruments	**3,510**	**0.16**	**0.15**
410,580	Gresham House Strategic [a]	3,510	0.16	
	Software & computer services	**61,320**	**2.84**	**1.78**
6,615,674	Actual Experience [a]	13,231	0.61	
11,302,515	Blancco Technology [a]	11,868	0.55	
120,629,158	eServGlobal [a]	5,790	0.27	
2,010,000	Micro Focus International	27,718	1.28	
2,916,666	Watchstone [a]	2,713	0.13	
	Technology hardware & equipment	**2,306**	**0.11**	**0.18**
7,951,272	Frontier Smart Technologies	2,306	0.11	
	Unquoted / unlisted [d]	**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	
Portfolio of investments		**2,161,991**	**100.09**	**100.19**

Portfolio statement (continued)

as at Holding		31.12.18 £'000	31.12.18 %	30.06.18 %
	CASH EQUIVALENTS	**480**	**0.02**	**0.00**
	'AAA' rated money market funds [e]	**480**	**0.02**	**0.00**
480,000	Northern Trust Global Fund - Sterling	480	0.02	
Total portfolio		**2,162,471**	**100.11**	**100.19**
Net other assets / (liabilities)		**(2,308)**	**(0.11)**	**(0.19)**
Net assets attributable to shareholders		**2,160,163**	**100.00**	**100.00**

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

[a] AIM quoted.

[b] Suspended.

[c] Related party to the fund.

[d] Unlisted.

[e] 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 six months to 31 December 2018

Largest purchases	£'000
Kier Group	19,707
Petrofac	12,733
Micro Focus International	11,412
Capita	8,084
fastjet	7,744
Mothercare	6,296
Mercantile Ports [a]	5,726
WH Ireland [a]	4,527
eServGlobal	3,477
BT Group	2,977
Other purchases	4,451
Total purchases	**87,134**

Largest sales	£'000
Carnival	30,558
BP	29,979
Entertainment One	22,937
HomeServe	21,770
Dixons Carphone	17,282
Aviva	16,223
Ei Group	16,100
Coats Group	13,604
Prudential [b]	13,207
Smiths Group	12,617
Other sales	81,591
Total sales	**275,868**

[a] AIM quoted.

[b] 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 Interim Long Report and unaudited 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.

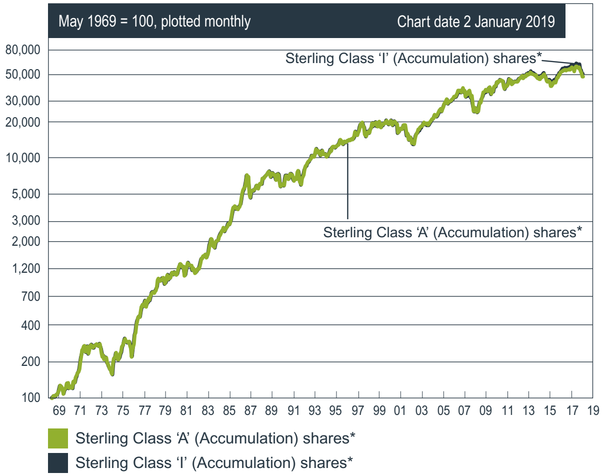
Fund level performance

Fund net asset value

as at	31.12.18 £'000	30.06.18 £'000	30.06.17 £'000
Fund net asset value (NAV)	2,160,163	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.

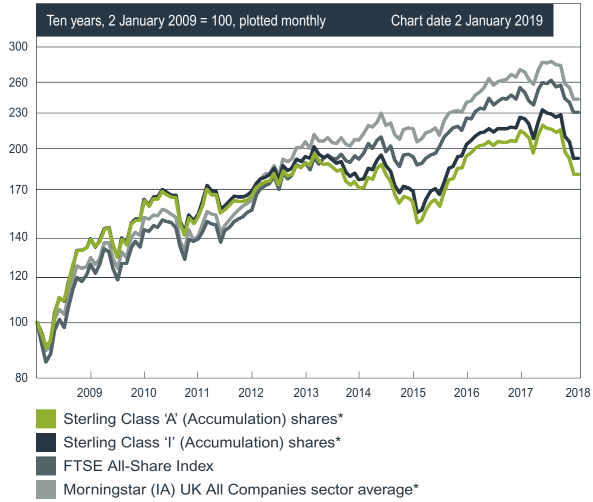


* Income reinvested

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.

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 period are calculated as at 11 January 2019.

Sterling Class 'A' Accumulation share performance

The share class was launched on 23 May 1969.

Change in NAV per share	Six months to 31.12.18 UK p	Year to 30.06.18 UK p	Year to 30.06.17 UK p
Opening NAV	346.76	323.47	254.06
Return before operating charges and after direct portfolio transaction costs	(55.99)	28.80	74.38
Operating charges	(2.74)	(5.51)	(4.97)
Return after operating charges	(58.73)	23.29	69.41
Distributions	(1.31)	(2.46)	(1.22)
Retained distributions	1.31	2.46	1.22
Closing NAV	288.03	346.76	323.47
Direct portfolio transaction costs	**UK p**	**UK p**	**UK p**
Costs before dilution adjustments	0.04	0.11	0.15
Dilution adjustments [a]	(0.03)	(0.08)	(0.13)
Total direct portfolio transaction costs	0.01	0.03	0.02
Performance and charges	**%**	**%**	**%**
Direct portfolio transaction costs [b]	0.00	0.01	0.01
Operating charges	1.66	1.66	1.66
Return after operating charges	-16.94	+7.20	+27.32
Historic yield	0.97	0.71	0.37
Effect on yield of charges offset against capital	0.00	0.00	0.00
Other information			
Closing NAV (£'000)	505,481	634,597	769,199
Closing NAV percentage of total fund NAV (%)	23.40	22.59	24.93
Number of shares	175,494,153	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.

Change in NAV per share	Six months to 31.12.18 UK p	Year to 30.06.18 UK p	Year to 30.06.17 UK p
Opening NAV	368.26	340.98	265.81
Return before operating charges and after direct portfolio transaction costs	(59.60)	30.48	78.06
Operating charges	(1.60)	(3.20)	(2.89)
Return after operating charges	(61.20)	27.28	75.17
Distributions	(2.67)	(5.24)	(3.68)
Retained distributions	2.67	5.24	3.68
Closing NAV	307.06	368.26	340.98
Direct portfolio transaction costs	**UK p**	**UK p**	**UK p**
Costs before dilution adjustments	0.04	0.11	0.15
Dilution adjustments [a]	(0.03)	(0.08)	(0.14)
Total direct portfolio transaction costs	0.01	0.03	0.01
Performance and charges	**%**	**%**	**%**
Direct portfolio transaction costs [b]	0.00	0.01	0.01
Operating charges	0.91	0.91	0.91
Return after operating charges	-16.62	+8.00	+28.28
Historic yield	1.77	1.43	1.06
Effect on yield of charges offset against capital	0.00	0.00	0.00
Other information			
Closing NAV (£'000)	474,014	643,242	672,526
Closing NAV percentage of total fund NAV (%)	21.94	22.89	21.80
Number of shares	154,369,634	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.

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

Direct portfolio transaction costs [b]	Six months to 31.12.18 %	Year to 30.06.18 %	Year to 30.06.17 %	Average [a] %
Broker commission	0.01	0.01	0.03	0.01
Taxes	0.01	0.02	0.02	0.02
Costs before dilution adjustments	0.02	0.03	0.05	0.03
Dilution adjustments [c]	(0.02)	(0.02)	(0.04)	(0.03)
Total direct portfolio transaction costs	0.00	0.01	0.01	0.00

as at Indirect portfolio transaction costs	31.12.18 %	30.06.18 %	30.06.17 %	Average [a] %
Average portfolio dealing spread	1.05	0.59	0.69	0.78

[a] Average of first three columns.

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

[c] In respect of direct portfolio transaction costs. Please see the section above this table for an explanation of dilution adjustments.

Notes

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