Quarterly Review

M&G (Lux) Conservative Allocation Fund

First quarter 2019

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FOR INVESTMENT PROFESSIONALS ONLY

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Highlights

- The fund delivered a positive return in the quarter, as investor worries generally unwound following an easing of interest rate expectations, low inflation forecasts and strong employment data.
- The recovery in global equities, especially in European and Asian markets, was the main source of positive return.
- While short positions in Western government bonds detracted, long positions in US, Mexican and Indonesian government bonds gained on dovish policy rhetoric from central banks.
- The equity risk premium remains elevated and the fund is positioned to exploit this.

Main risks associated with this fund:

For any past performance shown, please note that past performance is not a guide to future performance.

The value and income from the fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested.

The fund may use derivatives to profit from an expected rise or fall in the value of an asset. Should the asset's value vary in an unexpected way, the fund may lose as much as or more than the amount invested.

Investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the fund.

The fund is exposed to different currencies. Derivatives are used to minimise, but may not always eliminate, the impact of movements in currency exchange rates.

Further risk factors that apply to the fund can be found in the fund's Key Investor Information Document (KIID).

Things you should know:

The fund allows for the extensive use of derivatives.

Review of markets and fund performance

	3 months %	YTD %	1 year %	Since launch %[1]
M&G (Lux) Conservative Allocation Fund	2.9	2.9	-4.1	0.9
Morningstar EUR Cautious Allocation - Global sector average	3.8	3.8	0.1	-0.2

Single year performance (5 years)

	2018 %	2017 %	2016 %	2015 %	2014 %
Euro A	-7.7	5.8	9.2	N/A	N/A
Sector	-5.1	3.2	2.3	-0.1	5.8

Past performance is not a guide to future performance.

Source: Morningstar, Inc., Pan-European database as at 31 March 2019. Euro A class shares, income reinvested, price-to-price basis.

Past performance prior to 16 January 2018 is that of the M&G Prudent Allocation Fund (a UK-authorised OEIC) which merged into this fund on 16 March 2018. Tax rates and charges may differ.

[1] "Since launch" refers to the launch date of the M&G Prudent Allocation Fund, which was 23 April 2015.

Review of markets and fund performance

There was a meaningful recovery in risk appetite during the quarter – although the longer the period went on, the less inclined investors were to take bets on the likes of bank shares. This was due to a change in investors' interest rate expectations, Turkey's slide into recession and associated doubts centred on fiscal and monetary policies.

What helped initially with the rally was the change in rhetoric from the US Federal Reserve towards future interest rate increases and the comments made on January 30, which confirmed the Fed will be patient. This certainly relieved some of the pressure that had been exerted on financial markets for most of 2018 and which, in our view, was the central driver of heightened volatility and increased risk aversion throughout the period.

Global equities was the clear outperformer, certainly during the strong 'risk-on' environment of January and February. The fund's holdings of European, Asian and Japanese stocks, and sector baskets such as technology/biotech, green energy, and mining – as commodity prices ticked up – supported returns in the period. Bank holdings in aggregate generated a positive return, although there was a divergence between geographies, as a handful of European banks lost ground on balance sheet concerns. In March, however, banks across all regions underperformed as investors fretted about the sector's ability to make money in a scenario of low interest rates.

In contrast to the fourth quarter of 2018, the fund also lost money through its short position in the S&P 500 as US equities gained on a mixture of good macro news (employment and economic growth data) and solid company earnings.

Overall, fixed income positions generated a small positive return in the quarter, with contrasting fortunes from our long/short exposures. For example, the majority of the fund's long positions on emerging markets such as Mexico, South Africa and Indonesia contributed in the period, as prices of these bonds rose because pressure from rising US rates lessened. Long-dated Mexican government bonds, in particular, benefit when the Fed expresses dovish monetary policy sentiment.

On the other hand, our short positions in Western government bonds cost the fund, because these bonds also participated in this rally. In fact, global bond yields have been declining since October 2018 as growth fears have strengthened. This trend accelerated with increasingly dovish rhetoric from central bankers in March, which moved investors' mindset from expecting rate rises, to no increases, to potential rate cuts in the period ahead.

Some of these losses were offset by our long positions in US Treasuries, which we argue offer better value than core European bonds and provide a degree of welcome diversification

The modest allocation to corporate bonds made a small positive contribution in an environment of aggressively tightening spreads.

Fund management

As a demonstration of our dynamic approach to managing the fund, we were reasonably active in making portfolio changes over the course of the quarter.

The main trade took place in mid-February when we reduced the fund's equity weighting from around 34% – which had been the highest equity exposure in four years – to 30.2% at the end of March. This was in response to significant gains in European, Asian and Japanese stockmarkets. We had previously increased our risk weightings in October and December 2018, taking advantage of sharp falls in the markets during those periods.

As well as decreasing the weightings in a range of global markets, in February we also increased the short position in US equities after a strong rally.

Although we chose to cut our risk exposure, we are still positive on the outlook for equities. The fund therefore remains overweight in equities relative to its neutral position.

Within our fixed income allocation, in January we reduced exposure to Mexican government bonds and the peso after some strong performance. Mexican bonds is still our largest bet within emerging market debt, however, and continues to drive performance within the fund's modest bond position.

In February, we adjusted the fund's positioning on the US Treasury yield curve and increased our short positions in core European government bonds, including French (OAT) government bonds. Within US Treasuries, we closed the position on five-year bonds, which had rallied sharply since October, and opened a new position in 30-year bonds. We believe there is more diversification potential from holding longer-dated than shorter-dated US Treasuries.

We also increased our short positions in German bunds. These bonds held up fairly well despite the recent resurgence in risk appetite. In our opinion, a lack of rotation out of so-called safe-haven bets signals the persistent concern of investors about the deterioration of the global economic backdrop. We believe longer-dated core European government bonds are remarkably expensive – especially in comparison to their US counterparts – and are vulnerable to price falls, hence our short positions.

Finally, we increased the exposure to Indonesian government bonds on the five-year and 10-year local currency bonds. Pleasingly, this trade contributed to performance in the quarter.

Currency breakdown (%)	
	Net exposure
Euro	92.8
US dollar	8.0
Japanese yen	3.4
Mexican peso	3.3
Indonesian rupiah	2.7
Australian dollar	-2.3
Singapore dollar	-3.1
Taiwan dollar	-3.3
Chinese renminbi	-7.9
Other	6.2

Source: M&G, as at 31 March 2019.

Asset breakdown (%)			
	Long exposure	Short exposure	Net exposure
Equity	**36.7**	**-6.5**	**30.2**
UK	4.0	0.0	4.0
Europe	9.3	0.0	9.3
US	8.2	-6.5	1.8
Japan	7.1	0.0	7.1
Asia Pacific ex Japan	5.6	0.0	5.6
Global equity funds	0.0	0.0	0.0
Other	2.5	0.0	2.5
Government bonds	**33.5**	**-34.7**	**-1.2**
UK	0.0	-11.5	-11.5
Europe	8.4	-18.3	-9.9
US	12.8	0.0	12.8
Japan	0.0	-5.0	-5.0
Asia Pacific ex Japan	2.3	0.0	2.3
Other	10.0	0.0	10.0
Corporate bonds	**5.1**	**-5.3**	**-0.3**
Investment grade	4.5	0.0	4.5
High yield	0.6	-5.3	-4.8
Global bond funds	**2.8**	**0.0**	**2.8**
Convertible bonds	**2.1**	**0.0**	**2.1**
Property funds	**1.0**	**0.0**	**1.0**
Residual Cash			**65.4**

Source: M&G, as at 31 March 2019.

The residual cash (net exposure) figure includes cash-at-bank and cash equivalents, as well as cash required to back long and short exposures resulting from the use of derivatives. The residual cash should be considered in conjunction with the overall positioning of the portfolio (including gross exposure) for a true reflection of risk.

Outlook

So far in 2019, we have seen an unwinding of the exaggerated risk aversion that took hold in late 2018, although this may not continue. Hence, we have reduced risk to an extent, but are still guided by the valuation signals. At the moment, the most compelling opportunities still appear to be in equities, so we maintain diversified exposure across developed and emerging markets.

As ever, the macro environment is very mixed. While we continue to see low inflation rates in both developed and emerging markets, and strong employment levels – with wage growth also starting to pick up – there has been weak data from a trade and manufacturing perspective. Issues such as Brexit and Turkish politics (and the economy dipping into recession in March) also have a tendency to dominate the headlines.

The easing of pressure from rising interest rates coming from the Fed – and other central banks – is likely to be a major driving force for markets. In this regard, we will continue to monitor changes in the fundamentals and prevailing asset valuations in deciding how to position the portfolio in the future.

Our long positions in US Treasuries have provided a degree of welcome diversification in recent periods, and we also favour long positions in cheap emerging market government bonds that benefit from an easing in expectations of future interest rate rises. Given current valuations, many traditional 'safe' assets such as Western government bonds outside of the US now provide very little scope for portfolio protection. We suggest they could be very vulnerable to a change in risk preference.

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