Quarterly Review

M&G (Lux) European Strategic Value Fund

First quarter 2019

Fund manager – Richard Halle

FOR INVESTMENT PROFESSIONALS ONLY

Highlights

- European stockmarkets rose in the first quarter, buoyed by hopes of a trade deal between the US and China and the Federal Reserve's patient approach to rate rises. 'Value' as a style underperformed the broader market.
- The fund delivered positive returns but trailed the MSCI Europe Net Return Index, with stock selection in consumer staples and industrials detracting. In contrast, our energy stocks made a significant contribution.
- There were no new holdings during the quarter. We disposed of a number of small positions where we no longer feel the risk/reward is attractive. These included German bank Deutsche Bank, oil services firm Lamprell and Danish cigar maker Scandinavian Tobacco.

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 can be exposed to different currencies. Movements in currency exchange rates may adversely affect the value of your investment.

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 invests mainly in company shares and is therefore likely to experience larger price fluctuations than funds that invest in bonds and/or cash.

Important information

On 7 December 2018 the M&G European Strategic Value Fund, a UK-authorised OEIC which launched on 2 January 2008, merged into the M&G (Lux) European Strategic Value Fund, a Luxembourg-authorised SICAV, which launched on 18 September 2018. The SICAV is run by the same fund manager, applying the same investment strategy, as the UK-authorised OEIC.

Quarterly, YTD and long-term performance

	3 months %	YTD %	1 year %	3 years % p.a.	5 years % p.a.	Since launch[1] % p.a.
M&G (Lux) European Strategic Value Fund	9.5	9.5	-2.6	4.9	4.1	4.4
Comparative index	12.8	12.8	5.9	7.7	5.8	4.6

Single year performance (5 years)

	2018 %	2017 %	2016 %	2015 %	2014 %
Euro A	-14.4	10.7	3.5	10.0	6.6
Comparative index	-10.1	10.9	3.2	8.8	7.4

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.

Fund performance prior to 20 September 2018 is that of the EUR A class shares of the M&G European Strategic Value Fund, a UK-authorised OEIC, which merged into this fund on 7 December 2018. Tax rates and charges may differ. 'Since launch' refers to the launch date of the M&G European Strategic Value Fund's EUR A class shares, which was 1 February 2008.

Comparative index prior to 31 December 2011 is the FTSE World Europe Index, and from 1 January 2012 to 19 September 2018 it is the MSCI Europe Index, all stated as Gross Return. From 20 September 2018 the comparative index is the MSCI Europe Net Return Index. Net Return indices include dividends after the deduction of withholding taxes.

Performance attribution and positioning

Largest positive contributors 3 months			
Stock	Relative weight %	Absolute return %	Contribution %
Kosmos Energy	1.1	57.0	0.3
Next	1.3	45.6	0.3
Tullow Oil	1.5	39.9	0.3

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Next	1.3	45.6	0.3
Tullow Oil	1.5	39.9	0.3

Largest negative contributors 3 months			
Stock	Relative weight %	Absolute return %	Contribution %
Permanent TSB Group	0.8	-15.3	-0.2
Deutsche Lufthansa	1.9	-0.7	-0.2
Chemring Group	0.9	-10.3	-0.2

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Stock	Relative weight %	Absolute return %	Contribution %
Permanent TSB Group	0.8	-15.3	-0.2
Deutsche Lufthansa	1.9	-0.7	-0.2
Chemring Group	0.9	-10.3	-0.2

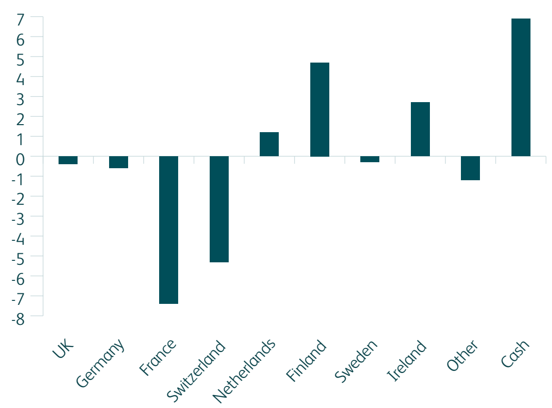
Source: Factset, investment returns calculated in euro, as at 31 March 2019, preliminary data. Performance contribution includes both stocks held and not held, and weighting shown is relative to MSCI Europe Index.

Largest overweights (%)			
	Fund	Index	Relative
Securitas	2.6	0.1	2.5
UPM-Kymmene	2.2	0.2	2.1
BP	3.7	1.7	2.0
Total	3.5	1.6	1.9
Deutsche Lufthansa	1.9	0.1	1.9
William Hill	1.8	0.0	1.8
Buzzi Unicem	1.8	0.0	1.8
Volkswagen	2.2	0.4	1.7
EI Group	1.7	0.0	1.7
Ahold Delhaize	2.0	0.4	1.7

Largest underweights (%)			
	Fund	Index	Relative
Nestle	0.0	3.4	-3.4
HSBC	0.0	1.9	-1.9
Unilever	0.0	1.8	-1.8
SAP	0.0	1.3	-1.3
GlaxoSmithKline	0.0	1.2	-1.2
LVMH	0.0	1.2	-1.2
Diageo	0.0	1.2	-1.2
BAT	0.0	1.1	-1.1
Novo Nordisk	0.0	1.1	-1.1
Allianz	0.0	1.1	-1.1

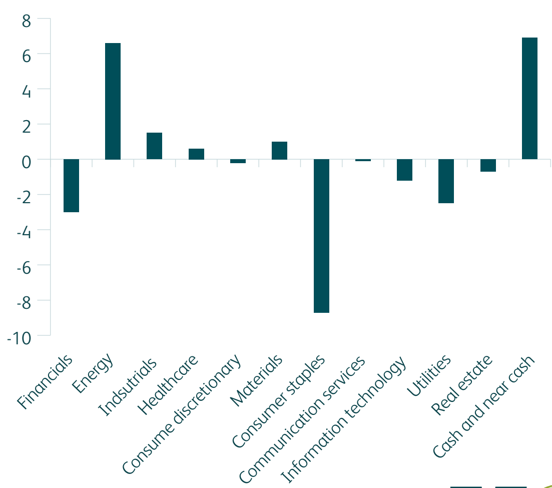
Country breakdown (%)					
	Fund (start)	Fund (end)	Change	Index (end)	Relative
UK	27.2	26.8	-0.4	27.2	-0.4
Germany	13.5	13.0	-0.5	13.6	-0.6
France	10.8	10.0	-0.8	17.4	-7.4
Switzerland	8.7	8.7	0.0	14.0	-5.3
Netherlands	6.3	6.8	0.5	5.6	1.2
Finland	6.8	6.3	-0.5	1.6	4.7
Sweden	4.1	3.9	-0.2	4.1	-0.3
Ireland	3.9	3.6	-0.3	0.9	2.7
Other	13.4	14.2	0.8	15.4	-1.2
Cash	5.3	6.9	1.6	0.0	6.9

Weights relative to index (%)



Industry breakdown (%)					
	Fund (start)	Fund (end)	Change	Index (end)	Relative
Financials	15.8	15.2	-0.6	18.2	-3.0
Energy	13.4	14.8	1.4	8.3	6.6
Industrials	15.4	14.5	-0.9	13.0	1.5
Healthcare	13.8	13.7	-0.1	13.1	0.6
Consumer discretionary	9.7	9.1	-0.6	9.2	-0.2
Materials	8.2	8.4	0.2	7.4	1.0
Consumer staples	5.9	6.0	0.1	14.7	-8.7
Communication services	5.3	4.8	-0.5	4.8	-0.1
Information technology	4.7	4.2	-0.4	5.5	-1.2
Utilities	1.8	1.7	-0.1	4.2	-2.5
Real estate	0.8	0.8	-0.1	1.4	-0.7
Cash and near cash	5.3	6.9	1.6	0.0	6.9

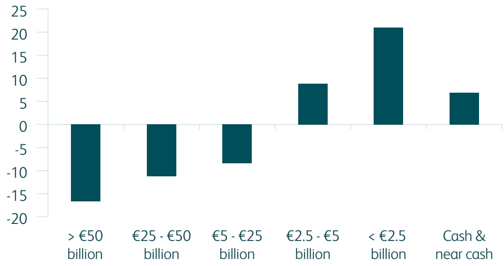
Weights relative to index (%)



Capitalisation breakdown (%)	Fund (start)	Fund (end)	Change	Index (end)	Relative
> €50 billion	26.4	29.4	3.0	46.1	-16.7
€25 - €50 billion	13.1	9.7	-3.4	21.0	-11.2
€5 - €25 billion	22.6	22.9	0.2	31.3	-8.4
€2.5 - €5 billion	8.8	10.1	1.3	1.3	8.8
< €2.5 billion	23.8	21.0	-2.8	0.0	21.0
Cash & near cash	5.3	6.9	1.6	0.0	6.9

Source of all portfolio data: M&G, as at 31 March 2019.
Index: MSCI Europe Index.

Weights relative to index (%)



Fund commentary

European stockmarkets made a positive start to 2019 as they rebounded in the first quarter from declines at the end of last year.

The improvement in sentiment was driven by optimism about progress in the trade negotiations between the US and China and the Federal Reserve's new patient approach to interest rate hikes.

These developments outweighed persistent concerns about the global economic outlook, as well as uncertainty about the UK's departure from the European Union. After the UK parliament repeatedly rejected the Withdrawal Agreement negotiated by the prime minister with the EU, the Article 50 Brexit deadline was extended until the end of October.

Meanwhile, worries about the health of the eurozone economy continued to unsettle investors. In light of lacklustre activity in the single currency zone, including weakness in Germany, the European Central Bank announced that interest rates would remain unchanged until the end of the year. The bank also unveiled further measures to support economic growth.

Against this background, there was a broad market rebound, with all sectors delivering positive returns. Consumer staples led the way, closely followed by information technology and materials. In contrast, communication services, which includes telecoms stocks, was the weakest area. Financials also underperformed, hurt by the challenging macroeconomic outlook and the prospect that interest rates will remain low for the foreseeable future.

In terms of style, 'value' was out of favour and lagged the broader market. Investors continued to favour more expensive 'quality' stocks offering steady growth, as demonstrated by the outperformance of consumer staples. In terms of size, smaller companies outperformed their larger counterparts.

The fund delivered positive returns in the quarter, but was behind the MSCI Europe Net Return Index, with stock selection in consumer staples and industrials detracting from relative performance.

In industrials, German airline Deutsche Lufthansa and Swedish security services firm Securitas were leading detractors. Investors are uncertain about Securitas' current investment plans, but we think they will be very beneficial for future profitability. In our view, Securitas is well placed to profit from the shift from manned guarding to more technologically-based security. In what regards Lufthansa, investors were disappointed by its profit forecast. Higher fuel costs and lower fares resulting from a competitive market are expected to weigh on performance.

As financials underperformed, our holdings in Spanish banks Bankia and CaixaBank and Irish lender Permanent TSB detracted. Permanent is currently investing heavily in its systems, and this is delaying a potential earnings recovery. Although the market is impatient for improvement, we believe the company has attractive prospects and its share price should re-rate in time.

Our significant below-index position in consumer staples also hurt relative performance as the sector outperformed. In addition, our holding in UK supermarket J Sainsbury detracted as it looks likely that the company's planned merger with rival Asda will not be allowed on competition grounds. Our holding in UK defence company Chemring was another laggard on weak results.

On a positive note, our allocation to energy made a significant contribution to performance. As oil prices rallied after declines at the end of last year, our holdings in oil & gas exploration firms Kosmos Energy and Tullow Oil, Norwegian marine seismic services firm Petroleum Geo-Services and BP added value. Investors welcomed plans by Kosmos and Tullow to pay dividends, in a sign of their improved financial position and healthy prospects.

UK fashion retailer Next was another contributor. In a challenging environment for retailers, the stock has rallied this year as it continues to deliver results above market expectations. Next's online business is becoming increasingly important and making up for declining profits in its stores.

In addition, UK pub company Ei maintained its positive momentum. In recent months, investors have been encouraged by the company's execution of its strategic plan. Ei sold a number of commercial properties during the quarter and plans to use the money to reduce debt and deliver returns to shareholders.

Portfolio activity

We sold a number of small positions where we no longer feel the risk/reward is attractive. These included German bank Deutsche Bank, oil services firm Lamprell and Danish cigar maker Scandinavian Tobacco. We also sold our entire holding in Turkish conglomerate Koc, which has performed well since we purchased it last August. Oil & gas explorer Ophir Energy left the portfolio after being taken over.

UK bookmaker GVC was another complete disposal. The stock fell during the period when the chief executive and chairman sold large numbers of shares. They insisted that they were committed to the company, but we closed our position as we were not convinced the management team was capable of executing their strategy.

There were no new holdings. However, we added to several existing positions including Dutch food retailer Ahold Delhaize, German car maker Volkswagen and Swedish security services firm Securitas. We remain comfortable with the portfolio and believe the fund has some very attractively valued holdings that could deliver promising returns over the long term.

In terms of positioning, the fund currently has a cyclical tilt with relatively large weightings in banks, energy, industrials and retailers. This is balanced by a large allocation to cash. In contrast, we continue to have a large underweight in consumer staples. Information technology and utilities are also below-index positions.

Outlook

We remain optimistic about the outlook for value investing in Europe. In our view, worries about the macroeconomic outlook have driven investors towards quality companies offering stable earnings in an uncertain environment. This trend has created a wide divergence in the market, and the valuation gap between the most expensive and the cheapest stocks is very stretched.

In our view, there is plenty of bad news already priced into cheaper 'value' stocks, and the bifurcation in the market today provides a very appealing risk/reward opportunity.

Nevertheless, we are aware of the myriad risks that could derail this picture. Economic growth in the eurozone is lacklustre, corporate earnings growth is expected to decline, and margins are likely to come under pressure. Political risks such as Brexit uncertainty and the populist government in Italy are also sources of concern, while the trade war has not yet been resolved.

These risks are arguably influencing investors' negative sentiment towards the region. However, as long-term investors, we see uncertainty and the accompanying volatility as a source of opportunity. We will continue to look beyond the macroeconomic worries and focus on finding cheap stocks with robust fundamentals that we think are being undervalued by other market participants.

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