Quarterly Review

M&G (Lux) Income Allocation Fund

First quarter 2019

Fund manager – Steven Andrew

FOR INVESTMENT PROFESSIONALS ONLY

Highlights

- Most stockmarkets rallied in the first quarter of 2019, with investors encouraged by the likelihood that interest rates will not rise further this year in either the US or Europe, as well as signs of progress in trade talks between the US and China. Government bond prices also rose, but lagged corporate bonds.
- The fund produced a positive return over the quarter with most of the performance generated by the allocation to equities, particularly positions in European financial stocks and financial and technology shares from the US.
- Since we remain comfortable with the positioning of the fund, we made no material changes during the quarter.

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.

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.

Quarterly, YTD and calendar year performance (5 years)

	3 months %	YTD %	1 year %	3 years % pa	5 years % pa	Since launch[1] % pa
M&G (Lux) Income Allocation Fund	5.8	5.8	-2.0	4.6	4.6	4.7
Morningstar EUR Moderate Allocation Global sector	5.9	5.9	0.1	2.8	2.7	3.0

	2018 %	2017 %	2016 %	2015 %	2014 %
M&G (Lux) Income Allocation Fund	-8.7	7.9	9.6	-1.8	15.2
Morningstar EUR Moderate Allocation Global sector	-7.6	6.2	3.7	0.7	6.8

Past performance is not a guide to future performance.

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

On 16 March 2018, the M&G Income Allocation Fund, a UK-authorised OEIC, which launched on 7 November 2013, merged into the M&G (Lux) Income Allocation Fund, a Luxembourg-authorised SICAV, which launched on 16 January 2018. The SICAV is run by the same fund manager, applying the same investment strategy, as the UK-authorised OEIC.

[1] Since launch refers to the launch date of the M&G Income Allocation Fund, which was 7 November 2013.

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Fund performance

Most stockmarkets started 2019 in a vigorously positive manner. Investors were encouraged by the less aggressive stance of the US Federal Reserve, which signalled that US interest rates were unlikely to rise again this year. Further positive stimulus came from the European Central Bank, which is also minded to keep interest rates stable, as well as signs of progress in trade talks between the US and China. This overcame persistent concern about declining economic growth and signs that corporate earnings forecasts were being reduced. Some of the largest gains were seen in China and the US, particularly among technology stocks, while Japan lagged. Most emerging markets also rose, although some, including Argentina and Turkey, suffered their own idiosyncratic problems.

Fixed income markets were also positive, as investors seized upon the more dovish stance of the US Federal Reserve. Government bond prices rallied significantly in March, although a higher appetite for risk throughout the quarter led investment grade and, especially, high yield corporates to outperform during the period. Credit spreads narrowed during the three months. The weakness of the euro relative to most other currencies boosted the returns of foreign assets to euro-based investors.

The fund produced a positive return over the quarter, with most of the performance generated by the allocation to equities, particularly positions in European financial stocks and financial and technology shares from the US. Useful contributions were also generated by UK equities and Japanese non-financial shares, although our stakes in Japanese bank equities were notable laggards.

Government bonds also added value as investors seized upon the more dovish stance of the US Federal Reserve. These also provided worthwhile diversification when our equities declined in March. Longer-dated US Treasuries contributed substantial value. Holdings of government bonds from Spain also rallied, while, among emerging markets, sovereign debt from Mexico rose in price, as did our holdings of corporate bonds.

Fund management

Although the moves in the equity markets are encouraging, we are comfortable retaining a bias towards the asset class given the scale of the falls experienced in late 2018. We still believe that the elevated level of the equity risk premium is a compelling valuation signal, making equities much more attractively valued than most mainstream government bonds.

The exception is US government bonds, which we hold to diversify the risk from our equity holdings and for their reasonable level of yield. We were heartened by the diversification properties that US Treasuries demonstrated in March. We remain comfortable with the position in US government bonds, but are closely monitoring indicators of inflationary pressure. With the Federal Reserve apparently comfortable with increasing wages and employment feeding through to higher inflation, we think higher inflation is a bigger risk than the US economy falling into recession. If inflation in the US does seem to be on the rise, we may scale back our position in US Treasuries.

Accordingly, we made no changes to the overall positioning of the portfolio during the quarter. We do not think fundamental data signals recession and hence retain a positive stance towards risk assets.

Distributed income by calendar year (pence per share)	
2014	31.5
2015	32.2
2016	33.4
2017	32.9
2018	33.6
12 months historical yield (as at 31 March 2019)	3.4

Past performacne is not a guide to future performance.

Currency breakdown (%)	Fund
Euro	72.0
US dollar	4.6
Mexican peso	3.1
Brazilian real	2.9
British pound	2.8
Japanese yen	2.7
Korean won	2.7
South African rand	2.6
Canadian dollar	2.5
Other	4.0

Asset breakdown (%)	
	Fund
Equity	**47.9**
UK	2.3
Europe	15.1
US	10.8
Japan	13.4
Asia Pacific ex Japan	3.5
Global equity funds	0.0
Other	2.7
Government bonds	**43.6**
UK	-0.6
Europe	9.8
US	22.2
Japan	0.0
Asia Pacific ex Japan	0.0
Other	12.2
Corporate bonds	**4.4**
Investment grade	2.1
High yield	2.2
Global bond funds	**1.5**
Convertible bonds	**0.0**
Property funds	**0.5**
Cash	**2.2**

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

Outlook

Although there was some short-term equity volatility in response to falls in US bond yields and the European Central Bank's surprisingly bearish tone, we are not convinced that global recession is likely. In fact, we think the outlook should be seen as positive for equities. Remember, US short-term bond yields are the basic building block of asset price valuations, being the risk-free rate used to discount future cashflows. The idea that US interest rates were on an ever-rising path had put considerable downward pressure on asset prices last year, so the likelihood that rates have reached a ceiling should now be supportive.

This, and the persistently high level of the equity risk premium, explains why we maintain a bias towards equities, which in general appear better value than most mainstream government bonds. We retain significant exposure to the equity of European, US and Japanese banks, as well as general Japanese shares, with the potential risk offset by meaningful holdings of longer-dated US Treasuries. The price of these bonds would be expected to increase if weaker US economic growth is evident. They also offer a relatively attractive yield. The fund holds higher-yielding government bonds from emerging markets as well.

We remain cautious on most other mainstream government bonds, since we believe these assets look increasingly overvalued and vulnerable to price falls in the event of better economic data and increased expectations of higher interest rates. Consequently, the fund holds no government bonds from Japan, the UK or Germany.

Although the first quarter of 2019 proved positive for global stockmarkets and for the fund, we saw, in late 2018, how quickly things can change. There are all manner of events that could cause investor sentiment to deteriorate, from unexpectedly poor, or even good, economic data, adverse signals on trade or an unforeseen geopolitical development. Therefore, it is important to keep a close eye on the fundamental economic and earnings data to gauge whether price movements are justified, or whether they might reverse. Investors have certainly not succumbed to complacency and much commentary continues to focus on the possibility of recession, a scenario that we do not believe fits the facts. In our view, there is still scope for potential surprises to the upside, although we acknowledge that we must also beware of our own possible complacency.

We see price volatility as a positive factor, since changes in asset prices and valuations should present investment opportunities that we can exploit using our valuation-driven approach. To generate the best returns for our investors, we will continue to invest in those areas of the market that we believe combine strong growth characteristics with attractive valuations, while diversifying the fund across asset classes, sectors and geographies.

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