M&G Episode Income Fund
Sterling Class I – Accumulation shares

Quarterly Fund Review as at 30 September 2019

Fund manager – Steven Andrew

For investment professionals only

Highlights

- Although investors endured a wave of panic selling in August, support from central banks enabled most stockmarkets to rise over the third quarter, particularly when measured in sterling terms. Concern about the health of the global economy led to strong rallies in government bond markets as well.
- The fund delivered a positive return over the quarter, with most holdings adding value. The largest contributions came from the allocations to mainstream government bonds and equities.
- We took advantage of strong rallies to reduce exposure to government bonds in Italy and the US, while increasing the stake in equities.

The 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.

Fund performance

	3 months (%)	YTD (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Since launch (%) p.a.
Sterling I Accumulation	4.0%	13.0%	7.2%	7.5%	6.7%	-
IA Mixed Investment 20-60% Shares sector	1.8%	10.1%	4.1%	4.3%	5.0%	-
Quartile ranking	1	1	1	1	1	-

Single year performance (5 years)

	2018	2017	2016	2015	2014
Sterling I Accumulation	-5.8%	10.3%	14.9%	-2.6%	13.7%
IA Mixed Investment 20-60% Shares sector	-5.1%	7.2%	10.4%	1.2%	4.8%
Quartile ranking	3	1	1	4	1

Past performance is not a guide to future performance.

Source: Morningstar, Inc and M&G, as at 30 September 2019. Returns are calculated on a price to price basis with income reinvested.
Benchmark returns stated in GBP terms.

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Portfolio construction (%)

	Net allocation range	Neutrality
Currency	Min 70% sterling or sterling hedged	
Equity	20-50	30.0
Fixed income	40-80	60.0
Other	0-20	10.0

Leverage and volatility

	Fund
Leverage	1.0x
Volatility	5.9%

Largest exposures (excl. cash, %)

	Fund
Japan equity	13.5
Us equity	13.0
US Government 20Y	11.9
Italy Government 30Y	5.2
US Government 30Y	4.6
Spain equity	3.8
Italy equity	3.2
M&G Property Portfolio	3.0
Brazil Government 5Y	3.0
Mexico Government 20Y	3.0

Currency breakdown (%)

	Fund
British pound	74.5
US dollar	4.5
Brazilian real	3.3
Mexican peso	3.0
Japanese yen	2.9
South African rand	2.9
Indonesian rupiah	2.1
Colombian peso	1.9
Hong Kong dollar	1.2
Other	3.7

Distributed income by calendar year (pence per share)

2012	4.1
2013	4.3
2014	4.1
2015	4.1
2016	4.5
2017	4.5
2018	4.6
12-month historic yield - Net (as at 30 September 2019)	**2.6%**

Asset breakdown (%)

	Port. beginning weight 30/06/19	Port. ending weight 30/09/19
Corporate bonds	**5.7**	**5.7**
High yield	0.7	1.0
Investment grade	2.3	2.6
Not rated	2.7	2.1
Equity	**46.1**	**48.3**
Asia-Pacific ex Japan	**3.6**	**3.3**
Australia	0.6	0.6
China	0.0	0.6
Hong Kong	0.6	1.1
Singapore	0.0	0.0
South Korea	2.3	0.9
Taiwan	0.1	0.1
Europe ex UK	**13.7**	**13.3**
Belgium	0.8	0.8
France	2.3	2.3
Germany	2.1	2.0
Ireland	0.3	0.2
Italy	3.0	3.2
Netherlands	1.0	0.9
Spain	4.1	3.8
Japan	**13.3**	**13.5**
North America	**12.7**	**15.3**
Canada	2.4	2.3
United States	10.3	13.0
Other	**0.4**	**0.4**
Brazil	0.4	0.4
UK	**2.4**	**2.5**
Government bonds	**38.0**	**35.2**
Asia-Pacific ex Japan	**0.1**	**0.1**
Malaysia	0.1	0.1
Europe ex UK	**10.2**	**6.6**
Italy	8.6	5.2
Poland	1.6	1.4
North America	**16.8**	**16.5**
United States	16.8	16.5
Other	**11.3**	**12.3**
Brazil	3.0	3.0
Chile	0.8	0.7
Columbia	1.4	1.9
Mexico	2.9	3.0
Peru	0.4	0.9
South Africa	2.8	2.7
Mutual Fund	**1.2**	**1.2**
M&G (Lux) EM Hard Currency Bond Fund	1.2	1.2
Property	**3.2**	**3.0**
Currencies & Cash	**5.8**	**6.6**

Source: Aladdin. Investment returns are absolute.

Contribution to fund performance (%)

	Port. contribution to return (local)
Corporate bonds	**0.3**
High yield	0.0
Investment grade	0.1
Not rated	0.2
Equity	**1.6**
Asia-Pacific ex Japan	**-0.2**
Australia	0.0
China	-0.1
Hong Kong	-0.1
Singapore	0.0
South Korea	-0.1
Taiwan	0.0
Europe ex UK	**0.1**
Belgium	0.0
France	0.1
Germany	0.0
Ireland	-0.1
Italy	0.3
Netherlands	0.0
Spain	-0.2
Japan	**0.9**
North America	**0.5**
Canada	0.0
United States	0.5
Other	**0.0**
Brazil	0.0
UK	**0.3**
Government bonds	**3.4**
Asia-Pacific ex Japan	**0.0**
Malaysia	0.0
Europe ex UK	**1.4**
Italy	1.4
Poland	0.0
North America	**2.1**
United States	2.1
Other	**0.0**
Brazil	-0.2
Chile	0.0
Columbia	0.0
Mexico	0.2
Peru	0.0
South Africa	-0.1
Mutual Fund	**0.1**
M&G (Lux) EM Hard Currency Bond Fund	**0.1**
Property	**0.0**
Currencies & Cash	**-1.1**

Source: Aladdin. Investment returns are absolute.

Commentary

The quarter began and ended well for the world's stockmarkets, as investors were encouraged by the efforts of central banks to support their economies and hopes that the US and China might be able to agree a trade deal. In between, however, investor sentiment deteriorated on resurgent trade conflict and fear about a possible recession, leading to sharp sell-offs in shares. Overall, most stockmarkets were modestly higher in local terms, although weakness in the pound against many other currencies boosted the returns to sterling-based investors. The best-performing stockmarkets included Italy, Brazil and Japan, while Hong Kong, China and other emerging markets lagged.

As a deteriorating economic outlook led to many central banks cutting interest rates during the review period, including the Federal Reserve (twice) and the European Central Bank, government bond markets rallied strongly, with yields falling to record lows. The prices of government bonds in Spain, Germany and the US rose markedly, with the strength feeding through to corporate bonds.

The fund generated a positive return over the quarter, with most holdings contributing to performance. Mainstream government bonds added most value as investors embraced the willingness of the world's central banks to facilitate accommodative policies to support their economies. They also provided useful diversification when our equities declined in August. The best performers were government bonds from the US and Italy.

Although our holdings of emerging market government bonds were modestly positive, currency weakness diminished the returns, in particular from Brazilian and South African bonds.

The allocation to equities, primarily positions in Japan and in US financial and technology stocks, also boosted performance. Holdings of equities in UK companies and European banks added value as well.

Among the few detractors was our exposure to equities in Asia, where share prices in Hong Kong were adversely affected by pro-democracy protests, and South Korea and China which suffered from persistent uncertainty over global trade.

Persistent uncertainty over Brexit led to material weakness in the pound over the quarter, particularly relative to the US dollar and Japanese yen, which boosted the returns from many overseas assets. However, our hedging activities (at least 70% of the fund is hedged back to sterling) detracted from performance.

Portfolio activity

The most significant portfolio activity was a reduction in the allocation to mainstream government bonds, with the proceeds being reinvested in equities, taking the proportion of the fund in the asset class close to the top of the expected range. We also bought emerging market government bonds.

Following strong rallies, we decided it was prudent to reduce our exposure to government bonds from Italy. However, we added to our government bonds from Colombia, Peru, Brazil and South Africa, attracted by their higher yields.

We tactically adjusted our weighting in US government bonds, scaling back holdings after price increases reduced the yield available, meaning that they were unlikely to provide as much diversification in the event of weakness in equity markets. Subsequent price weakness enabled us to rebuild the position.

When equity prices fell in August we took the opportunity to add to our holdings in the US, Hong Kong and China. On the other hand, we scaled back positions in South Korea.

As a result of the changes, the cash position decreased during the quarter.

Outlook

Although data from the manufacturing sector signals a slowdown in activity, other indicators, such as those from the services sector, as well as inflation, employment and housing, all appear robust. Therefore, we remain comfortable with the way the portfolio is positioned. This leads us to continue to back the equity risk premium, particularly as most Western government bonds still appear extremely overvalued.

We continue to favour banking shares in Europe, the US and Japan, in the belief that their earnings are likely to grow and that they remain undervalued. We also like emerging market government bonds, as they provide attractive levels of yield and should provide a degree of diversification from other assets.

We maintain exposure to Italian government bonds, albeit at a lower level than at the beginning of the period, as they still provide an attractive yield spread over bunds. We also have significant holdings of long-dated US Treasuries, both for their reasonable level of yield and, although we do not expect it, as insurance against a possible recession.

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

Although 2019 has proved positive for global stockmarkets and for the fund so far, there have been a couple of months when investors suddenly panicked and sold equities. There are all manner of events that could cause investor sentiment to deteriorate, from a further escalation in trade conflict or unexpectedly poor economic data. On the other hand, surprisingly good economic data that caused investors to alter their expectations of the direction of interest changes could lead to a sell-off in Western government bond markets. There is also the possibility of unforeseen geopolitical developments, such as greater tension between the US and Iran or escalating conflict as Turkey moves into Syria. 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. Many investors remain concerned about the possibility of recession, a scenario that we do not believe fits the facts.

In our view, there is still scope for potential positive surprises, although we acknowledge that we must also be aware of our own possible complacency.

We see price volatility as a positive factor, since changes in asset prices and valuations can present investment opportunities that we may be able to 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, robust income delivery and attractive valuations, while diversifying the fund across asset classes, sectors and geographies.

Cash may be held on deposit and/or in the Northern Trust Cash Funds, a range of collective investment schemes.

The M&G Episode Income Fund is a sub-fund of M&G Investment Funds (11).

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