M&G Optimal Income Fund
Sterling Class A – Accumulation shares

Quarterly Fund Review as at 30 September 2019

Fund manager – Richard Woolnough

For investment professionals only

Highlights

- The third quarter of 2019 was positive for bond markets as central banks cut rates in an scenario of increasing volatility and mixed economic data.
- The fund delivered a modest positive return, supported by exposure to investment grade credit.
- As credit spreads have tightened, we have steadily de-risked within sectors such as telecoms and financials.
- We maintain that the global economic outlook is solid, and accordingly the fund remains underweight duration risk.

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.

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.

High yield bonds usually carry greater risk that the bond issuers may not be able to pay interest or return the capital.

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 will incur a loss. The fund's use of derivatives may be extensive and exceed the value of its assets (leverage). This has the effect of magnifying the size of losses and gains, resulting in greater fluctuations in the value of 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.

Fund performance

	3 months (%)	YTD (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Since launch (%)
Sterling A Accumulation	0.6%	5.9%	3.1%	3.1%	2.8%	-
IA £ Strategic Bond sector	2.0%	8.3%	6.9%	3.2%	3.8%	-
Quartile ranking	4	4	4	3	4	-

Single year performance (5 years)

	2018	2017	2016	2015	2014
Sterling A Accumulation	-3.8%	5.2%	7.7%	-1.2%	4.7%
IA £ Strategic Bond sector	-2.5%	5.2%	7.0%	-0.3%	6.2%
Quartile ranking	3	2	2	3	3

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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Asset breakdown (%)

	Fund	Short	Long	Net
Government bonds	28.2	-5.1	0.0	23.1
Investment grade corporate bonds	53.5	-3.9	0.0	49.6
Fixed rate	44.5	-0.1	0.0	44.4
Floating rate	8.9	0.0	0.0	8.9
Index linked	0.1	0.0	0.0	0.1
Credit default swap indices	0.0	-3.8	0.0	-3.8
High yield corporate bonds	9.0	0.0	0.0	9.0
Fixed rate	7.9	0.0	0.0	7.9
Floating rate	1.2	0.0	0.0	1.2
Index linked	0.0	0.0	0.0	0.0
Credit default swap indices	0.0	0.0	0.0	0.0
Securitised	3.0	0.0	0.0	3.0
Equities	5.2	0.0	0.0	5.2
Cash	1.1	0.0	0.0	1.1
Other	0.0	0.0	0.0	0.0

Credit rating breakdown (%)

	Physical	Short (via CDS)	Long (via CDS)	Net
AAA	26.0	0.0	0.0	26.0
AA	7.3	0.0	0.0	7.3
A	6.9	0.0	0.0	6.9
BBB	43.1	-4.4	0.0	38.8
BB	8.6	-4.6	0.0	3.9
B	1.6	0.0	0.0	1.6
CCC	0.2	0.0	0.0	0.2
CC	0.1	0.0	0.0	0.1
C	0.0	0.0	0.0	0.0
D	0.0	0.0	0.0	0.0
No rating	5.2	0.0	0.0	5.2
Cash	1.1	0.0	0.0	1.1

Country breakdown (%)

	Physical	Short (via CDS)	Long (via CDS)	Net
US	29.6	0.0	0.0	29.6
Germany	26.7	0.0	0.0	26.7
UK	20.3	-0.1	0.0	20.3
France	8.4	0.0	0.0	8.4
Italy	3.0	0.0	0.0	3.0
Belgium	1.9	0.0	0.0	1.9
Netherlands	1.8	0.0	0.0	1.8
Japan	1.7	0.0	0.0	1.7
Other	5.6	-1.7	0.0	3.9
Investment Grade indices	0.0	-3.8	0.0	-3.8
Cash	1.1	0.0	0.0	1.1
Other	0.0	-3.4	0.0	-3.4

Largest issuers (excluding government bonds and CDS indices, %)

	Fund
AT&T	3.3
Microsoft	2.9
Altria Group	1.9
Anheuser Busch	1.9
Bank of America	1.6
Verizon Communications	1.3
Lloyds Banking Group	1.3
Vodafone Group	1.2
Orange	1.2
Aviva	1.1

Maturity breakdown (%)

	Physical
0 - 1 years	3.8
1 - 3 years	14.8
3 - 5 years	12.7
5 - 7 years	10.2
7 - 10 years	17.7
10 - 15 years	8.6
15+ years	31.1
Cash	1.1

Currency breakdown (%)

	Pre-hedge	Post-hedge
British pound	28.3	99.4
US dollar	33.5	0.3
Euro	36.2	0.3
Swiss franc	0.2	0.0
Japanese yen	1.7	0.0
Singapore dollar	0.0	0.0
South African rand	0.0	0.0

Industry breakdown (%)

	Physical	Short (via CDS)	Long (via CDS)	Net
Sovereign	26.4	0.0	0.0	26.4
Telecommunications	10.5	0.0	0.0	10.5
Banking	10.3	0.0	0.0	10.3
Consumer goods	6.2	0.0	0.0	6.2
Technology & electronics	4.5	0.0	0.0	4.5
Automotive	3.5	0.0	0.0	3.5
Insurance	3.3	0.0	0.0	3.3
Asset backed	3.2	0.0	0.0	3.2
Basic industry	3.2	0.0	0.0	3.2
Healthcare	2.9	0.0	0.0	2.9
Utility	2.4	0.0	0.0	2.4
Media	2.4	0.0	0.0	2.4
Energy	2.1	0.0	0.0	2.1
Foreign Sovereign	1.9	-1.7	0.0	0.2
Real Estate	1.6	0.0	0.0	1.6
Covered Bonds	1.6	0.0	0.0	1.6
Retail	1.6	-0.1	0.0	1.5
Commercial Mortgage Backed	1.5	0.0	0.0	1.5
Mortgage backed	0.9	0.0	0.0	0.9
Transportation	0.7	0.0	0.0	0.7
Financial services	0.6	0.0	0.0	0.6
Leisure	0.6	0.0	0.0	0.6
Services	0.6	0.0	0.0	0.6
Capital goods	0.5	0.0	0.0	0.5
Supranational	0.4	0.0	0.0	0.4
Agency	0.3	0.0	0.0	0.3
Government Guaranteed	0.1	0.0	0.0	0.1
Quasi & foreign government	0.0	-3.4	0.0	-3.4
Investment Grade indices	0.0	-3.8	0.0	-3.8
Other	5.2	0.0	0.0	5.2
Cash	1.1	0.0	0.0	1.1

Duration by currency and asset class

	Fund	Futures	Swaps	Net
Euro	1.3	-1.1	0.0	0.2
British pound	2.2	-0.9	-0.7	0.8
US dollar	3.5	-3.1	0.0	0.3
Other	0.2	0.0	0.0	0.2
Total	7.2	-5.0	-0.7	1.5

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Market and fund performance

Following a flurry of market activity at the end of June, the third quarter began in more muted fashion. European government bond yields continued to decline, supported by broadly weaker-than-expected economic data in Europe and a dovish European Central Bank (ECB). In the US, government bond yields increased slightly, as economic data remained resilient. At the end of July, the US Federal Reserve (Fed) cut interest rates for the first time since 2008, citing benign inflation, lingering trade tensions, and weak global growth (especially in the manufacturing sector) as increasing downside risks to the economic outlook. In the UK, newly appointed Prime Minister Boris Johnson's pledge that Brexit will happen in October "no matter what" put downward pressure on sterling.

August was unpredictable and uncertain for markets as trade tensions, weak economic data and the prospect of renewed central bank activity diminished the appetite for risk assets, while boosting demand for 'safe-haven' government bonds. The latter posted the majority of the positive returns for the month, sourced from top-performing UK gilts (mainly on Brexit fears), US Treasuries and German bunds. The yields on core government bonds, including Italian government bonds (BTPs), all fell to record lows in the period. For the first time since 2007, the US Treasury yield curve inverted, with 10-year bonds yielding less than two-year bonds, and this was taken as a sign of imminent recession by many commentators. Within the credit markets, returns were generally more subdued, with high yield names in particular more sensitive to the risk-off behaviour of many investors.

The final few weeks of the quarter became increasingly active as investors focused on a series of interest rate moves from major central banks. Both the Fed and the ECB cut interest rates, while the Bank of England held rates (at 0.75%) although it did include 'lower for longer' language on the rising risk of a 'no-deal' Brexit. Volatility persisted too, driven by the prospect of the latter and, more significantly, concerns over the US economy – its manufacturing sector showing signs of increasing weakness despite continued accommodative policy from the Fed.

However, against this uncertainty, core government bond yields failed to behave as they did in July and August, rallying higher in the first half of September. This perhaps was an indication that expectations for further monetary loosening had been extremely high. Subdued data towards the end of the month put downward pressure on yields again. Credit initially rallied on the ECB's announcement of 'QE infinity', but heavy supply from the primary corporate bond market subsequently weighed heavily on spreads.

The fund generated a modest positive return over the quarter, with performance driven primarily by its investment grade credit exposure. As in previous quarters, our preference for quality corporate debt, particularly issued in US dollars, were important contributors here and we took profits when appropriate. For example, we sold bond holdings in companies like pharmaceuticals firm Mylan, where spreads tightened more than 100 basis points in July alone following news that the company planned to merge with Pfizer. Financials and selected euro-denominated credit also boosted performance in the period.

The fund did lose money during the period as a result of being more exposed to movements in credit spreads, which widened in August on heightened risk aversion while government bond yields continued their downward trend. Losses were mitigated through the fund's short position in emerging market government bonds, notably Argentinian bonds. Bond prices slumped by as much as 50% as primary elections revealed a low vote for the coalition of incumbent President Macri, heightening the country's financial uncertainty ahead of an October general election.

Within Western government bonds, we slightly reduced eurozone exposure, selling some Italian (in both euro and sterling) and long-dated French government bonds on strong performance, adding to returns in the process. As a result of September's surprise rally in government bond yields, being short interest rate exposure meant we offset price falls in German bunds and US Treasuries particularly early in the month.

The fund also benefited from its equity exposure, which remained low/steady at around 5% of asset allocation in the quarter. As yields trended higher, banks' securities had a good end to the period, as earnings expectations rose. Towards the end of the period, the fund also received a boost from the marginal compression in spreads, notably in US dollar-denominated investment grade corporates as they outperformed both sterling and euro credit in the period under review.

Portfolio positioning

We maintained our strategy of reducing credit exposure in response to further tightening in credit spreads. We remained selective in where we do this, with a focus on banks and telecoms during the quarter. Compared to a year ago, European credit especially is holding less relative return potential, particularly in the context of expected further monetary easing in the region. In this regard, with spreads tightening, we bought some more defensive and high-rated asset-backed securities. The yield on these instruments also have a 0% floor, which is quite useful to have in this environment of negative-yielding debt elsewhere.

There was modest activity in high yield, although it is still around 10% of asset allocation and mainly in BB rated names compared to bonds rated as single B or lower. Within government bonds, in addition to trimming eurozone exposure, we added some gilts and long-dated Treasury futures (in July), which looked relatively more attractive – the curve had been steepening for quite some time in the latter.

A key tactical play for us in the quarter centred around taking advantage of a mismatch in how the market is pricing inflation expectations over the coming years. In August, we bought Japanese and eurozone inflation-linked bonds, given they are attractively priced against a backdrop of negative-to-zero inflation expectations. In September and in a reverse move, we initiated a short position on UK inflation bonds through 10-year swaps. In our view, UK inflation is looking expensive and, arguably, fully discounting a fall in sterling post Brexit. In addition, the development in attempts to reform the Retail Prices Index (RPI) could add pressure on mid-to-long-dated linkers, as at some juncture (2025 onwards) they might reference the Consumer Prices Index plus housing costs (CPIH). At last count, this index was around 0.9 percentage points below the RPI.

As yields and spreads have sustained their fall, some equities began to look more attractive again. We added selectively over the period, although keeping exposure at 5%. We sold some of our exposure to Axa and Standard Chartered, while topping up some positions in automobile stocks and added Imperial Tobacco in September at an attractive yield.

We did add some duration to the portfolio during the quarter, for example in August, through the Japanese inflation-linked bonds trade (although the bulk of duration still stems from sterling assets). However, we maintain a very underweight duration position, on the view that the global economy is stronger than the consensus opinion of 'near recession'.

Outlook

Based on our healthier opinion of the global economy, we continue to think that investors are being paid to own a basket of attractively priced investment grade corporate bonds over less attractive core government bonds. This tactical decision is especially true in markets less distorted by recent central bank policy changes (particularly US investment grade credit). And because we think the global economy is not in this near-state of recession, it makes sense for us to question whether these interest rate cuts need to occur. Therefore we remain, as we have done for some time now, relatively short of interest rate risk.

Overall, our healthier view of the global economy means we maintain our very underweight duration position, derived mainly from holding sterling-denominated assets where the market does not expect major changes in interest rates in the near term. In contrast, the US and Europe are both set for fairly aggressive policy easing in the coming months.

We are mindful that having a short duration position within the fund means we have sometimes missed out on returns otherwise captured by strategies that bet on the global economy worsening, and monetary policy easing in mitigation. Certainly, an accumulation of mounting trade tensions, nerves around various emerging market issues, and noise around relatively weaker economic growth have all driven demand for core government bonds. This means prices on the likes of UK gilts, German bunds

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and US Treasuries have risen in response, pushing down yields, sometimes into negative territory. So we have the peculiar situation of investors choosing to pay some governments for the privilege of holding their debt.

In our view, the fund's ability to 'go anywhere' with bonds means that, as value investors, we can take advantage of situations when we believe markets are misaligned, which often they are. For example, when interest rates are too low or too high, or when credit spreads are too wide or too narrow, we can take advantage of these market mispricings. An asset class we believe is showing signs of mispricing is inflation-linked bonds, as mentioned.

Finally, a major theme this year for us has been trying to take advantage of the 'Armageddon-like' conditions priced by the market, to what has become a broader concern of an economic slowdown. This has been reflected in changes to prices and valuations, which we have taken advantage of as they occur, particularly in telecoms and financials. We would also include Brexit as giving us the scope to potentially make meaningful tactical bets, whatever form it takes after the deadline. Whatever the outcome – and it is impossible to guess – we nonetheless believe it could lead to some potential mispricing of assets. Sectors or credits could get mispriced in the aftermath and this could lead to investment opportunities from an interest rate, credit, or asset allocation point of view.

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

Sector performance is based on the Sterling I share class. This information is not available for the Sterling A share class.

The M&G Optimal Income Fund is a stand alone OEIC.

Sector: Morningstar category averages represent the average return of funds within their category over time. The category averages are created by using the average daily total return index series, or TRI, as well as monthly, quarterly, and annual averages of return and non-return data. Morningstar applies a fractional weighting methodology whereby, on the last day of each month, the funds are equally weighted and the share classes within each fund are equally weighted. Fractional weighting ensures that funds with multiple share classes do not dominate and skew the returns of the average, thus presenting the peer group performance in a fair and consistent manner.

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