M&G UK Inflation Linked Corporate Bond Fund Sterling Class I – Accumulation shares

Quarterly Fund Review as at 30 September 2019

Fund manager – Ben Lord

For investment professionals only

Highlights

• Fixed income markets continued their solid run in the third quarter of 2019, supported by the prospect of further stimulus measures from the world's central banks.

• The fund delivered a modest positive return in the quarter, helped by a rise in UK and European breakeven rates.

• The fund remains defensively positioned across all three of its key performance levers – duration, inflation and credit risk. Spread duration remains near its lowest level since the fund's launch, as we continue to scale back credit risk on the back of recent market strength.

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.

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 may invest more than 35% in securities issued by any one or more of the governments listed in the fund prospectus. Such exposure may be combined with the use of derivatives in pursuit of the fund objective. It is currently envisaged that the fund's exposure to such securities may exceed 35% in the UK government, although these may vary subject only to those listed in the prospectus.

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	0.8%	4.1%	2.7%	2.4%	1.5%	-
UK Consumer Price Index	0.5%	1.2%	1.7%	2.4%	1.6%	-
Quartile ranking	4	4	4	4	4	-

Single year performance (5 years)

	2018	2017	2016	2015	2014
Sterling I Accumulation	-1.0%	2.3%	5.8%	-1.7%	-0.7%
UK Consumer Price Index	2.1%	2.9%	1.6%	0.2%	0.6%
Quartile ranking	3	2	4	4	4

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 (%)

	Net
Government inflation linked	21.4
Corporate inflation linked	11.3
Synthetic inflation linked	38.9
Fixed rate bonds	19.6
Floating rate notes	9.1
Other	0.0
Cash	-0.2

Credit rating breakdown (%)

	Physical	Short (via CDS)	Long (via CDS)	Net
AAA	10.4	0.0	0.0	10.4
AA	60.8	0.0	0.0	21.9
A	7.8	0.0	2.8	10.7
BBB	17.9	0.0	36.0	53.9
BB	3.3	0.0	0.0	3.3
B	0.0	0.0	0.0	0.0
CCC	0.0	0.0	0.0	0.0
CC	0.0	0.0	0.0	0.0
C	0.0	0.0	0.0	0.0
D	0.0	0.0	0.0	0.0
No rating	0.0	0.0	0.0	0.0
Cash	-0.2	0.0	0.0	-0.2

Country breakdown (%)

	Physical	Short (via CDS)	Long (via CDS)	Net
UK	73.3	0.0	2.0	46.6
US	16.7	0.0	4.6	11.2
Germany	3.7	0.0	2.3	6.0
Mexico	0.0	0.0	2.8	2.8
Belgium	0.0	0.0	2.3	2.3
Canada	2.1	0.0	0.0	2.1
Netherlands	0.9	0.0	1.0	1.9
Spain	1.2	0.0	0.0	1.2
Other	2.3	0.0	0.5	2.8
Investment Grade indices	0.0	0.0	23.2	23.2
Cash	-0.2	0.0	0.0	-0.2

Largest issuers (excl. government bonds and CDS indices, %)

	Fund
Anglian Water	2.3
Tesco	2.2
Royal Bank of Canada	2.1
Nationwide Building Society	2.0
Lanark Master Issuer	1.8
BAT Capital	1.5
RBS	1.4
Energy Transfer	1.3
Orsted	1.2
Bank of Scotland	1.2

Maturity breakdown (%)

	Physical
0 - 1 years	36.7
1 - 3 years	15.7
3 - 5 years	34.2
5 - 7 years	11.0
7 - 10 years	0.4
10 - 15 years	1.2
15+ years	1.0
Cash	-0.2

Currency breakdown (%)

	Pre-hedge	Post-hedge
British pound	77.6	100.0
Euro	5.3	0.0
US dollar	17.2	0.0

Industry breakdown (%)

	Physical	Short (via CDS)	Long (via CDS)	Net
Sovereign	60.3	0.0	0.0	21.4
Banking	8.8	0.0	0.0	8.8
Mortgage backed	7.0	0.0	0.0	7.0
Asset backed	5.2	0.0	0.0	5.2
Automotive	2.8	0.0	0.0	2.8
Energy	2.8	0.0	0.0	2.8
Consumer goods	2.4	0.0	2.3	4.8
Covered Bonds	2.4	0.0	0.0	2.4
Retail	2.3	0.0	0.0	2.3
Real Estate	1.2	0.0	0.5	1.7
Insurance	1.1	0.0	0.0	1.1
Healthcare	0.9	0.0	1.4	2.3
Government Guaranteed	0.8	0.0	0.0	0.8
Financial services	0.7	0.0	0.0	0.7
Telecommunications	0.5	0.0	5.5	6.0
Technology & electronics	0.5	0.0	0.0	0.5
Utility	0.4	0.0	0.0	0.4
Transportation	0.2	0.0	0.0	0.2
Supranational	0.0	0.0	0.0	0.0
Basic industry	0.0	0.0	2.3	2.3
Capital goods	0.0	0.0	1.6	1.6
Commercial Mortgage Backed	0.0	0.0	0.0	0.0
Investment Grade indices	0.0	0.0	23.2	23.2
Other	0.0	0.0	2.0	2.0
Cash	-0.2	0.0	0.0	-0.2

Duration by currency and asset class

	Fund	Futures	Swaps	Net
Euro	0.2	-0.1	0.0	0.1
British pound	1.7	-0.9	-0.4	0.4
US dollar	0.5	0.2	0.0	0.7
Other	0.0	0.0	0.0	0.0
Total	2.3	-0.8	-0.4	1.1

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Commentary

Fixed income markets continued their solid run in the third quarter of 2019, supported by the prospect of further stimulus measures from the world's central banks. This helped drive strong performance across core government bonds, which saw yields fall to records lows in many parts of the market. Government bonds also benefited from their perceived safe haven attributes as escalating trade war tensions, rising Brexit fears and deteriorating economic data all weighed on investor sentiment.

In the UK, Boris Johnson's appointment as prime minister triggered further weakness in sterling as markets priced in the increased likelihood of a 'no-deal' Brexit. However, gilts performed strongly, with 10-year yields declining from 0.8% to 0.5% over the quarter.

Core government bonds were amongst the best-performing assets, with US Treasuries (+2.5%), bunds (+2.1%) and in particular gilts (+6.2%) all delivering strong returns. Plummeting government bond yields helped drive solid returns in investment grade corporate bonds, although credit spreads were little change over the quarter.

The fund delivered a modest positive return in the quarter. Holding a small amount of duration meant the fund gained some benefit from the sharp decline in government bond yields. A rise in UK and European breakeven rates also helped fund performance. Gains, though, were partly offset by weakness in US breakeven rates, where we maintained some exposure.

It should be noted that the fund's index-linked gilt positions consist entirely of very short-dated instruments, which meant the fund was not affected by the announcement of potential changes to the Retail Prices Index (RPI), which led to a sharp sell-off in longer-dated linkers in early September.

Portfolio positioning

Given the risk of a 'no-deal' Brexit and political uncertainty in the UK, we continue to focus on very short-dated UK linkers. These instruments are less correlated to movements in sterling – which we expect to remain highly volatile – as well as being largely immune to any future reforms to the RPI, which would be unlikely to occur before 2025 at the earliest.

The fund continues to be defensively positioned from an interest rate perspective. With both of the main political parties in the UK favouring increased fiscal stimulus, and with 10-year gilt yields falling to ever lower levels, we believe a cautious approach is warranted.

We also continued to reduce credit risk in the fund, selling down a number of US credits and European financials where valuations looked less compelling after recent strong performance. In their place, we have been switching into higher rated issues, including some AAA rated residential mortgage-backed securities (RMBS).

In terms of our non-UK index-linked exposure, we took the opportunity to switch out of index-linked bunds into US Treasury Inflation-Protected Securities (TIPS), after European breakeven rates rose sharply following the ECB's policy announcement in September. We failed to see why the ECB's measures would have any meaningful impact on European inflation and we currently see more upside potential in US breakeven rates.

Outlook

The fund remains defensively positioned across all three of its key performance levers – duration, inflation and credit risk. Spread duration remains near its lowest level since the fund's launch, as we continue to reduce credit risk on the back of recent market strength.

We believe UK inflation will continue to be driven by movements in sterling. The currency weakened sharply over the quarter amid growing fears of a 'no-deal' Brexit. This in turn has had a positive impact on UK breakeven rates as the market starts to price in higher inflation.

Given the fund's significant exposure to UK index-linked bonds, we think it would be well placed to directly benefit from any further rise in UK inflation expectations due to ongoing sterling weakness. Furthermore, the fund's short duration profile should help offset volatility in gilt markets. In the event of a political crisis, we think gilt yields could potentially rise meaningfully as markets start to price in increased levels of credit risk for the UK government.

It is worth noting that the fund maintains only a modest exposure to UK credit; instead we favour US credit, where we see better value and which is not directly affected by political developments in the UK. On a similar basis, the fund also has a modest exposure to non-UK index-linked government bonds, such as US Treasury Inflation-Protected Securities (TIPS).

Please note that the UK Consumer Price Index has been calculated using an estimate for the last month, using the previous month's annual rate, and the actual figure may be higher or lower than that shown.

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

The M&G UK Inflation Linked Corporate Bond Fund is a sub-fund of M&G Investment Funds (10).

Where a security has not been rated by Standard & Poor's, Fitch or Moody's, we may use M&G's internal credit rating. Based on a comparison of all available ratings for each security, the most conservative rating (S&P, Fitch, Moody's or M&G's internal rating) is taken into consideration. The ratings so identified are then expressed or converted into M&G's ratings format to obtain uniform information for all securities in the portfolio.

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