M&G Corporate Bond Fund
Sterling Class I – Accumulation shares
Quarterly Fund Review as at 30 June 2020
Fund manager – Richard Woolnough
For investment professionals only

Highlights

• With many economies bolstered by massive government and central bank support, risky assets rebounded strongly from the sharp falls of the previous quarter.
• Investment grade credit rallied, fuelled by heavy market activity and central banks buying corporate bonds to support liquidity.
• Duration is at its maximum short, based on a deep pessimism of any further downward movement in UK rates in the coming period.
• The portfolio continues to focus on companies with straightforward businesses, and a tilt to reflationary sectors given the current environment.

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

<table>
<thead>
<tr>
<th></th>
<th>3 months (%)</th>
<th>YTD (%)</th>
<th>1 year (%)</th>
<th>3 years (%) p.a.</th>
<th>5 years (%) p.a.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sterling I Accumulation</td>
<td>8.5%</td>
<td>0.9%</td>
<td>5.1%</td>
<td>1.9%</td>
<td>4.8%</td>
</tr>
<tr>
<td>Sector</td>
<td>7.6%</td>
<td>2.7%</td>
<td>5.7%</td>
<td>4.0%</td>
<td>4.8%</td>
</tr>
<tr>
<td>Quartile ranking</td>
<td></td>
<td>2</td>
<td>4</td>
<td>3</td>
<td>3</td>
</tr>
</tbody>
</table>

Single year performance (5 years)

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Sterling I Accumulation</td>
<td>11.3%</td>
<td>-2.5%</td>
<td>5.3%</td>
<td>8.6%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Sector</td>
<td>9.5%</td>
<td>-2.2%</td>
<td>5.1%</td>
<td>9.0%</td>
<td>-0.4%</td>
</tr>
<tr>
<td>Quartile ranking</td>
<td>1</td>
<td>3</td>
<td>2</td>
<td>3</td>
<td>2</td>
</tr>
</tbody>
</table>

Past performance is not a guide to future performance.
Sector: IA Sterling Corporate Bond sector
The benchmark is a target which the fund seeks to outperform. The sector has been chosen the benchmark as the fund is a constituent of the sector. The benchmark is used solely to measure the fund’s performance and does not constrain the fund’s portfolio construction.
The fund is actively managed. The fund manager has complete freedom in choosing which investments to buy, hold and sell in the fund.

Source: Morningstar, Inc and M&G, as at 30 June 2020. Returns are calculated on a price to price basis with income reinvested.
Benchmark returns stated in GBP terms.

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Asset breakdown (%) | Credit rating breakdown (%) | Country breakdown (%)
---|---|---
| Government bonds | 4.6 | -0.4 | 0.0 | 4.2 |
| Investment grade corporate bonds | 82.0 | 0.0 | 0.0 | 82.0 |
| Fixed rate | 68.3 | 0.0 | 0.0 | 68.3 |
| Floating rate | 13.2 | 0.0 | 0.0 | 13.2 |
| Index linked | 0.5 | 0.0 | 0.0 | 0.5 |
| Credit default swap indices | 0.0 | 0.0 | 0.0 | 0.0 |
| High yield corporate bonds | 4.2 | 0.0 | 0.0 | 4.2 |
| Fixed rate | 3.5 | 0.0 | 0.0 | 3.5 |
| Floating rate | 0.7 | 0.0 | 0.0 | 0.7 |
| Index linked | 0.0 | 0.0 | 0.0 | 0.0 |
| Credit default swap indices | 0.0 | 0.0 | 0.0 | 0.0 |
| Securitised | 5.5 | 0.0 | 0.0 | 5.5 |
| Equities | 0.0 | 0.0 | 0.0 | 0.0 |
| Other | 0.0 | 0.0 | 0.0 | 0.0 |
| Cash | 3.8 | 0.0 | 0.0 | 4.2 |

<table>
<thead>
<tr>
<th>Largest issuers (excl. government bonds and CDS indices, %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund</td>
</tr>
<tr>
<td>Thames Water</td>
</tr>
<tr>
<td>Lloyd’s Banking Group</td>
</tr>
<tr>
<td>Microsoft</td>
</tr>
<tr>
<td>BAT International Finance</td>
</tr>
<tr>
<td>AT&amp;T</td>
</tr>
<tr>
<td>Imperial Brands Finance</td>
</tr>
<tr>
<td>Legal &amp; General</td>
</tr>
<tr>
<td>Snf Reseau</td>
</tr>
<tr>
<td>Gatwick Funding</td>
</tr>
<tr>
<td>Arvia</td>
</tr>
</tbody>
</table>

Industry breakdown (%) | Maturity breakdown (%) | Currency breakdown (%)
---|---|---
| Physical | Short (via CDS) | Long (via CDS) | Net | Physical | Short (via CDS) | Long (via CDS) | Net | Pre-hedge | | Post-hedge |
| Telecommunications | 10.6 | 0.0 | 0.0 | 10.6 |
| Utility | 10.2 | 0.0 | 0.0 | 10.2 |
| Asset backed | 9.8 | 0.0 | 0.0 | 9.8 |
| Banking | 9.4 | -0.4 | 0.0 | 9.0 |
| Consumer goods | 9.0 | 0.0 | 0.0 | 9.0 |
| Insurance | 6.9 | 0.0 | 0.0 | 6.9 |
| Real Estate | 5.0 | 0.0 | 0.0 | 5.0 |
| Commercial Mortgage Backed | 4.0 | 0.0 | 0.0 | 4.0 |
| Covered Bonds | 4.0 | 0.0 | 0.0 | 4.0 |
| Energy | 3.8 | 0.0 | 0.0 | 3.8 |
| Sovereign | 2.8 | 0.0 | 0.0 | 2.8 |
| Technology & electronics | 2.7 | 0.0 | 0.0 | 2.7 |
| Agency | 2.5 | 0.0 | 0.0 | 2.5 |
| Media | 2.2 | 0.0 | 0.0 | 2.2 |
| Basic industry | 2.2 | 0.0 | 0.0 | 2.2 |
| Automotive | 2.1 | 0.0 | 0.0 | 2.1 |
| Foreign Sovereign | 1.8 | 0.0 | 0.0 | 1.8 |
| Retail | 1.6 | 0.0 | 0.0 | 1.6 |
| Mortgage backed | 1.0 | 0.0 | 0.0 | 1.0 |
| Healthcare | 0.9 | 0.0 | 0.0 | 0.9 |
| Transportation | 0.9 | 0.0 | 0.0 | 0.9 |
| Financial services | 0.9 | 0.0 | 0.0 | 0.9 |
| Supranational | 0.8 | 0.0 | 0.0 | 0.8 |
| Capital goods | 0.7 | 0.0 | 0.0 | 0.7 |
| Leisure | 0.4 | 0.0 | 0.0 | 0.4 |
| Services | 0.4 | 0.0 | 0.0 | 0.4 |
| Government Guaranteed | 0.2 | 0.0 | 0.0 | 0.2 |
| Cash | 3.8 | 0.0 | 0.0 | 4.2 |

<p>| Duration by currency and asset class (years) |</p>
<table>
<thead>
<tr>
<th>Fund</th>
<th>Futures</th>
<th>Swaps</th>
<th>Net</th>
</tr>
</thead>
<tbody>
<tr>
<td>Euro</td>
<td>0.4</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>British pound</td>
<td>6.0</td>
<td>-0.1</td>
<td>0.0</td>
</tr>
<tr>
<td>US dollar</td>
<td>2.1</td>
<td>-1.6</td>
<td>0.0</td>
</tr>
<tr>
<td>Other</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Total</td>
<td>8.5</td>
<td>-1.9</td>
<td>0.0</td>
</tr>
</tbody>
</table>
Commentary

With economies now bolstered by massive government and central bank support, risky assets rebounded strongly from the record lows of March, when the coronavirus pandemic began to halt large parts of economic activity. Even in light of poor data – jobs particularly – and earnings results, and forecasts of worse to come in terms of falls in growth over the coming quarters, investors bought assets that had cheapened significantly during March’s dive downturn.

As the second quarter drew to a close with the majority of core assets having seen a strong rally, the year-to-date performance of a number of bonds moved into positive territory: US investment grade credit, alongside safe-haven favourites such as US Treasuries, UK gilts, and German bunds. Although both had a decent second quarter, European corporate bonds trailed UK corporate bonds, despite the euro performing well against other major currencies in the period.

Commodities including gold, performing its traditional role as a safe-haven bet in uncertain times, and oil, also rallied. The former had been punished heavily by investors in the period before, as doubts about the economic outlook began to mount.

High yield and emerging market debt, riskier bond bets that had previously seen heavy selling from nervous investors, also saw a decent recovery. In the early stage of the second quarter, a lack of unequivocal support from the European Central Bank weighed on peripheral eurozone bonds, particularly those of Italy.

As it became apparent that governments and central banks were willing to involve themselves in helping the economy on a scale not seen for generations, investors began to buy more riskier bonds. US high yield, for instance, rallied strongly as the US Federal Reserve announced, at the end of March, it would buy high yield ETFs (exchange traded funds) to shore up market activity. By June, the Fed had started to buy physical corporate bonds (targeting a “Broad Market Index”), which made valuations less cheap (credit spreads tightened) as the second quarter ended.

Performance, portfolio activity and positioning

The fund produced a positive return in the quarter and benefited from the rebound in risk assets, particularly investment grade paper issued by US and UK companies. We saw some strong performances from BBB rated names – our preferred bet – and also picking up new issues at an attractive price were major contributors to returns compared to the previous quarter.

By the end of the quarter, our credit spread duration was around 8.7 years – roughly 0.3 years overweight the iBoxx Sterling Corporate Index – and this benefited the fund as the price of corporate bonds rose. Bonds that contributed to performance in the period include those issued by UK insurers, Aviva and Legal & General, and tobacco companies Philip Morris, Altria and British American Tobacco (BAT). These companies have fairly straightforward businesses and operate in sectors that can, typically, weather recessions. However, being underweight UK financials compared to the benchmark detracted from relative performance in the period.

In terms of exposure to interest rate risk, while we added some duration last quarter (mainly in the UK rates curve) as we headed into a period of unprecedented market stress, we have since gone back to being maximum short on the view rates have little room to move lower in the coming months. At the end of the quarter, duration was about 6.7 years, or -1.5 years underweight the iBoxx Sterling Corporate Index, compared to around 7.0 years or -0.7 years vs the index at the end of March.

We have been very active in trades this quarter, taking advantage of some attractive prices for bonds issued in the aftermath of March’s sharp correction, then consolidating through relative value trades and the secondary market. Companies added include defensive favourites Philip Morris, Exxon, Tesco, Thames Water and Experian. In April, for the first time in a long time, we bought a few utility companies’ bonds with maturity dates of around 5-7 years. Valuations within this sector were fairly compelling given the lockdown – and sudden halt in economic activity – that we all endured.

By the end of the period, we had removed some risk outright by selling some of the shorter-dated sterling bonds that had performed well in April/May, like Severn Trent Water, Aviva, Land Security, Oxford University and Welcome Trust. Strong performing US dollar credits including IBM were also sold. We used the proceeds to shore up longer-dated sterling exposures in bonds from SSE Power and Bupa. The addition of healthcare names adds to the defensive/reflationary part of our portfolio, given the uncertain situation we currently face.

Outlook

We continue to back the valuation signal offered by the debt issued by companies with straightforward business models and fairly steady cashflows – a relatively uncomplicated portfolio of plain vanilla bonds issued by companies at the higher end of the BBB rated universe. With the tilt to reflationary sectors, we hope the fund will be in a good position to benefit once we come out of the crisis, even if the UK ends up in a deeper recession than forecast.
Important information

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

The M&G Corporate Bond Fund is a sub-fund of M&G Investment Funds (3).

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.

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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