M&G (Lux) Optimal Income Fund

Investment update

Richard Woolnough, Fund Manager

August 2021

- Tight valuations and some uncertainly about the future means it is more important than ever to have a flexible approach focused on active return generation.
- US dollar investment grade corporate bonds have driven performance; equities, duration have also helped.
- We remain constructive on corporate bonds, while our exposure to inflation-linked bonds and cyclical equities means the portfolio is well-positioned for an inflationary environment, in our view.
- Our interest rate outlook remains defensive – we believe higher economic growth and inflation will force government bond yields higher.

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 and you may get back less than you originally invested. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested.

A flexible approach to unlocking active returns

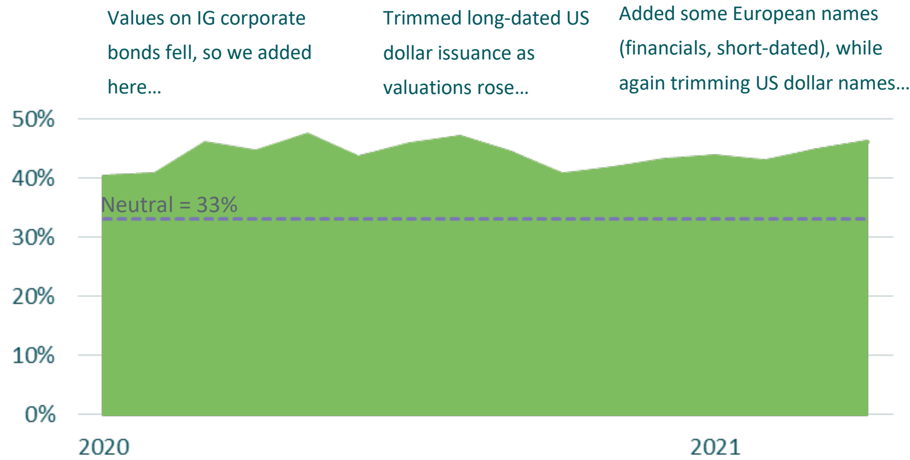
In an uncertain world where valuations remain tight, like the one we navigate today, a fully flexible fund with a clear focus on active return generation is more important than ever, in our view. The M&G (Lux) Optimal Income Fund is one of the most flexible bond funds within our M&G Wholesale Fixed Income range. Since the strategy was launched in 2006, we have been able to move freely between asset classes, including investment grade corporate bonds, high yield bonds, government bonds, and equities (the latter up to 20%).

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.

In the first six months of 2021 – a period that we believe has been more settled, slightly more predictable, and with more certainty compared to 2020 – we have continued to have portfolio exposure that favours high quality corporate bonds. Exposure is currently about 44-45% -- not the highest it has been for the fund, but well above neutral (33%). Exposure has also remained fairly steady since the onset of global pandemic-induced volatility (see Figure 1 overleaf).

However, within investment grade we have been actively reducing exposure to US dollar credit, particularly longer-dated issuance as these bonds performed well (in spread terms). On the other hand, we have been adding to European credit, as spreads look relatively attractive and support from the European Central Bank remains elevated. Within this asset class, we favour financials because of what we see attractive valuations, and also banks, as they are benefiting from the strong rebound in growth.

Figure 1. Fund exposure to investment grade corporate bonds since March 2020

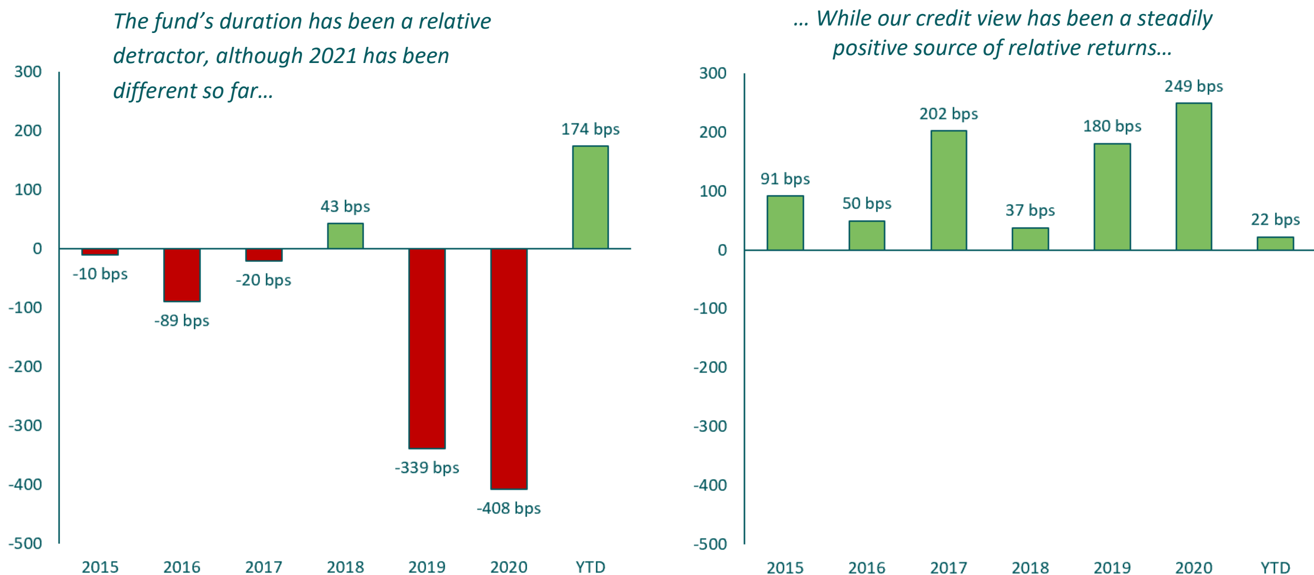


Source: M&G, 30 June 2021. Please note, portfolio data is based on internal sources, is unaudited and may differ from information as shown in the Monthly Fund Review. Information is subject to change and is not a guarantee of future results.

Performance H1 – boosted by duration *and* credit views

We consider two main factors driving the performance of any fixed income fund: interest rate risk (duration) and credit risk (spread). Over the last few years, we have adopted a relatively cautious duration position as we believe that government bonds do not provide an attractive income stream – a long way from being optimal. While this view has not always been a performance contributor (apart from 2018), in 2021 it has been of benefit as these assets (US Treasuries, UK gilts, German bunds) have come under some selling pressure, which has pushed yields higher. At the same time, our credit exposure also contributed positively to performance (see Figure 2) as the macroeconomic environment remains broadly benign for spreads. Within credit, our exposure to long-dated US dollar investment grade names was particularly helpful as these bonds generated solid returns.

Figure 2. Active return coming from duration and from spread



Past performance is not a guide to future performance.

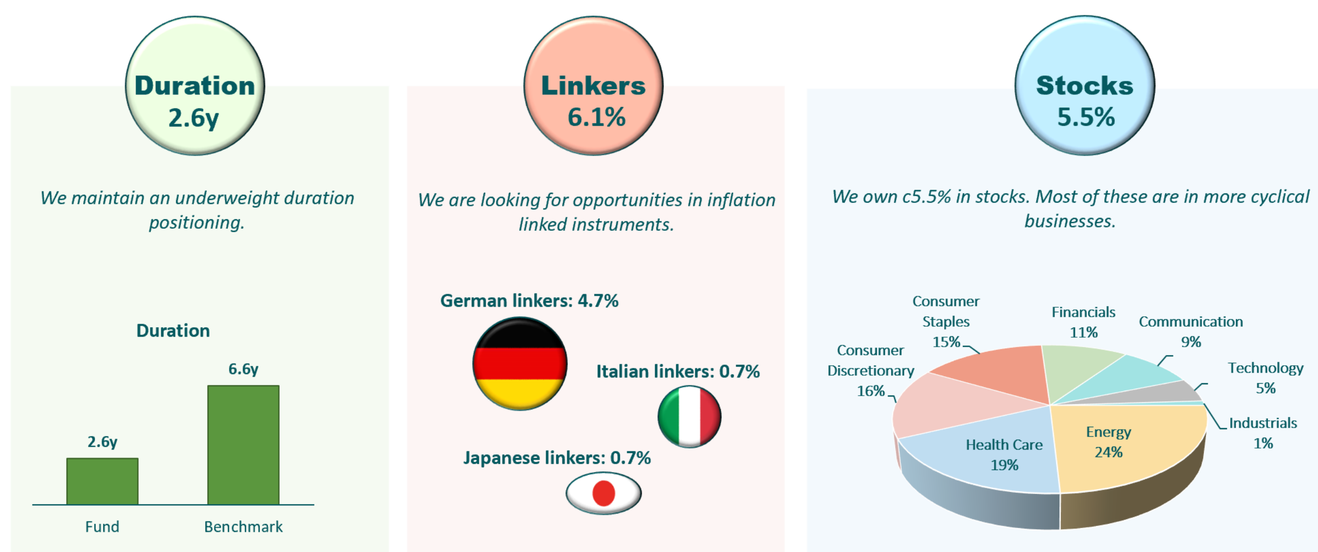
Source: M&G, 30 June 2021. Please note, portfolio data is based on internal sources, is unaudited and may differ from information as shown in the Monthly Fund Review. On 8 March 2019, the non-sterling assets of the M&G Optimal Income Fund, a UK-authorised OEIC, merged in the M&G (Lux) Optimal Income Fund, a Luxembourg authorised SICAV, which launched on 5 September 2018. Data prior to 8 March 2019 refers to the OEIC.

Aside from duration and credit, other sources of fund return in this period have included equities exposure and some inflation assets such as inflation-linked bonds ('linkers'). The fund currently invests around 5-6% of its portfolio in equities, so well below the 20% maximum permitted. But the exposure that we do have is in shares issued by companies operating in cyclical sectors, and this has largely worked for us as the global economy reopens and investor interest in energy and automobile firms gathers speed. Meanwhile our holdings of inflation-linked bonds have also helped somewhat, as investors have started to buy protection against the prospect of rising prices.

Portfolio positioning in light of a reflationary environment

We believe the fund is well-positioned for a reflationary environment – one where economic output expands due to fiscal and monetary stimulus efforts. It has less interest rate risk (duration) compared to the benchmark index, a healthy (in our view) allocation to linkers, and, as mentioned, equity exposure to mainly cyclical businesses (see Figure 3). Our portfolio duration of 2.6 years as at 30 June 2021 means we remain underweight by around four years versus the benchmark index. This low duration position is consistent with our negative view of interest rate risk: We believe higher growth and eventually higher inflation will put further pressure on government bonds, particularly at the long end of the curve.

Figure 3. Well-positioned for a reflationary environment



Source: M&G, 30 June 2021. Please note, portfolio data is based on internal sources, is unaudited and may differ from information as shown in the Monthly Fund Review. Information is subject to change and is not a guarantee of future results.

There have been no major changes to our risk-free exposure (cash and government bonds) during the period – it stands at around 30% of fund assets – although we have added exposure to some emerging markets and peripheral European government bonds (mainly Italy). Importantly within the context of a reflationary environment, we continue to look for opportunities in linkers to complement current holdings of German, Japanese and Italian inflation assets.

Investing in emerging markets involves a greater risk of loss due to greater political, tax, economic, foreign exchange, liquidity and regulatory risks, among other factors. There may be difficulties in buying, selling, safekeeping or valuing investments in such countries. 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.

Within equities, we are also identifying some opportunities, particularly as credit spreads continue to tighten. As mentioned, exposure to stocks was around 5.5% versus a portfolio maximum of 20%. This exposure is in mainly cyclical businesses that could benefit from the full reopening of the global economy in the later stages of 2021 and 2022.

While high yield continues to be an underweight for the fund (15-16% exposure versus a neutral weight of 33.3%), we have added some exposure in the period mainly using derivatives. On a risk-adjusted basis, we think high yield is looking more attractive compared to investment grade corporate bonds, particularly in an environment where default rates remain low.

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.

Finally, holding high-quality investment grade bonds issued by what we consider to be well-managed US, UK, and European companies remains the fund's biggest conviction, at around 44-45% of total assets.

Outlook

As we enter the final stages of 2021 – a year that has been certainly more settled than last year – we continue to see credit spreads as historically tight. However, we believe the strong economic recovery coupled with accommodative monetary policy should keep default rates on corporate bonds low, which in turn is supportive for spreads. On the other hand, we believe long-dated government bond yields will continue to rise, reflecting the better macroeconomic outlook.

Figure 4. Fund performance year to date (%) and five calendar years (% pa)

	YTD	2020	2019	2018	2017	2016
Fund (EUR)	2.0	1.4	6.8	-4.0	4.3	7.0
BM* (EUR)	-0.5	4.9	7.8	N/A	N/A	N/A

Past performance is not a guide to future performance

*The composite index – 1/3 Bloomberg Barclays Global Agg Corporate Index EUR Hedged; 1/3 Bloomberg Barclays Global High Yield Index EUR Hedged; 1/3 Bloomberg Barclays Global Treasury Index EUR Hedged – was introduced as the fund's benchmark on 7 September 2018.

The benchmark is a comparator against which the fund's performance can be measured. The composite index has been chosen as the fund's benchmark as it best reflects the scope of the fund's investment policy. 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 investment manager has complete freedom in choosing which investments to buy, hold and sell in the fund. The fund's holdings may deviate significantly from the benchmark's constituents.

Source: Morningstar, Inc., as at 30 June 2021, Euro A Acc share class, price to price, income reinvested.

Fund performance prior to 7 September 2018 is that of M&G Optimal Income Fund (a UK-authorised OEIC), which merged into this fund on 8 March 2019. Tax rates and charges may differ.

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The fund allows for the extensive use of derivatives.

Further risks associated with the fund can be found in the fund's Key Investor Information Document.

UCITS HAVE NO GUARANTEED RETURN AND PAST PERFORMANCE IS NOT A GUIDE TO FUTURE PERFORMANCE

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Information Document/s which is available in Greek, from the Greek Representative: Eurobank Ergasias S.A. 8, Othonos Street, 10557 Athens.

Before subscribing investors should read the Prospectus, which includes a description of the investment risks relating to these funds. The value of the assets managed by the funds may greatly fluctuate as a result of the investment policy.

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