M&G (Lux) Optimal Income Fund

Investment update and outlook

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April 2022

- It has been a volatile few months for markets and the majority of fixed income asset classes have produced a negative return.
- Based on our macro view and where valuations are, we believe the fund can benefit from tighter credit spreads and rising government bond yields in coming periods.
- Year-to-date, the fund has generated a negative return driven by wider spreads and higher government bond yields. However, the fund outperformed its benchmark mainly thanks to its more cautious duration positioning.
- Duration ended the quarter at around 3.8 years, the highest it has been for a while. It was lengthened at the short-dated end of the yield curve, while we are still underweight at the long-end.

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. Where any performance is mentioned, please note that past performance is not a guide to future performance.

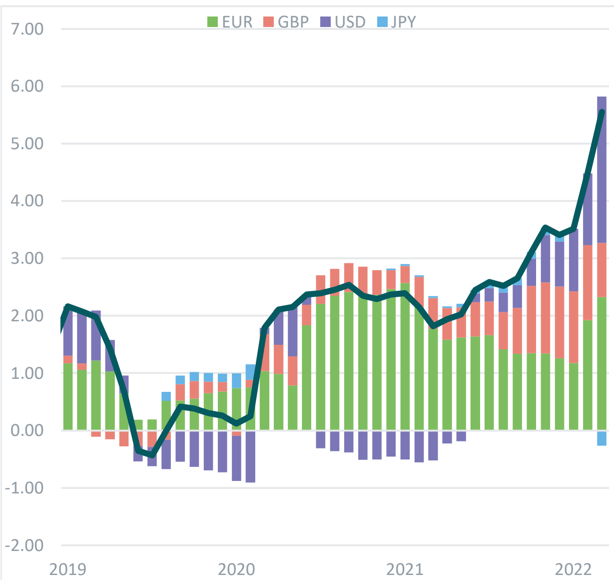
Positioning and Outlook

The appetite for bonds had already been poor in recent months because of accelerating inflation and central bank interest rate hikes. Russia's invasion of Ukraine on February 24 and subsequent international developments have weighed even further on market sentiment. Despite this, for some time now we have remained constructive on the economy and this is integral to our portfolio positioning as we head into the spring and summer.

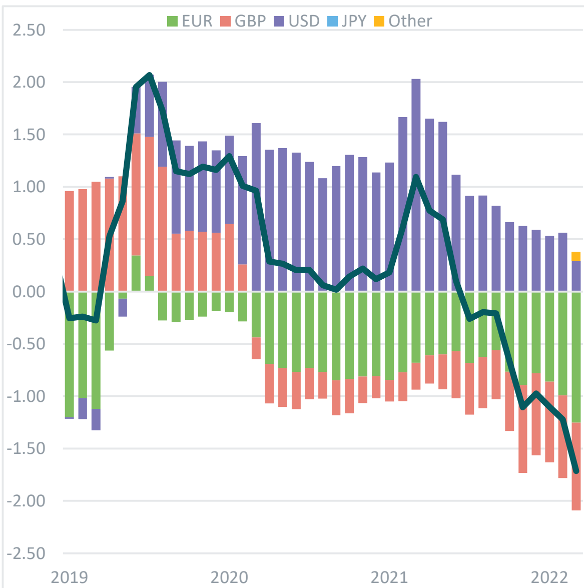
Monetary and fiscal stimulus has worked, in our view, perhaps even too well: inflation across major markets is high, but labour markets are extremely strong, wages are rising and households are in a good financial position. Meanwhile, central banks have not kept pace with interest rate rises and remain behind the curve – we still have negative real rates. As long as this continues, we believe that corporate bond defaults should stay low, which in turn should be positive for credit. And while central banks have recently turned more hawkish (particularly in the US and UK), their current and projected rates are still far below where inflation is.

Figure 1: Duration by currency and maturity

0-10 years



10+ years



Source: M&G, 31 March 2022. 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.

Given this macroeconomic backdrop, while we acknowledge that tail risks (indicating a higher probability of rare events) have increased, we remain constructive on the economy. We are therefore positioned for interest rates to go up and default rates to remain low.

Credit

Credit spreads have experienced high volatility this year, but given our view expressed above, we do not think the risk of default has materially changed (clearly with a few exceptions related to the conflict between Russia and Ukraine). As a result, we maintain a positive view on credit and expect spreads to tighten from here.

We have recently made some changes within our credit allocation. In particular, we added exposure to high yield (mainly through the derivatives market) and have been active in the primary market, where delayed issuances have resulted in price dislocations (a high new issue premium). High yield exposure, as a percentage of total fund assets, is now around 30% and closer to our neutral weighting of 33%.

Equities

Although the M&G (Lux) Optimal Income Fund invests in government and corporate bonds from anywhere in the world, including emerging markets, and of any credit quality, it can also invest up to 20% in equities. Our equity allocation, which is predominantly made of low price-to-earnings companies, has performed well this year. However, the yield differential between the equities we own and bonds has generally compressed. As a result we are reducing our allocation to stocks that performed well and gradually moving back into bonds. Exposure, as a percentage of total fund assets, is now just below 4% (as at end March 2022).

Duration

The main change we have carried out to the portfolio so far this year has been in our positioning towards interest rate sensitivity (duration). We remain underweight duration, relative to the benchmark, but given the move in government bond yields, we have been adding some duration back. So far this year we moved our duration from 2.4 years to 3.8 years. Our benchmark has 6.5 years of duration.

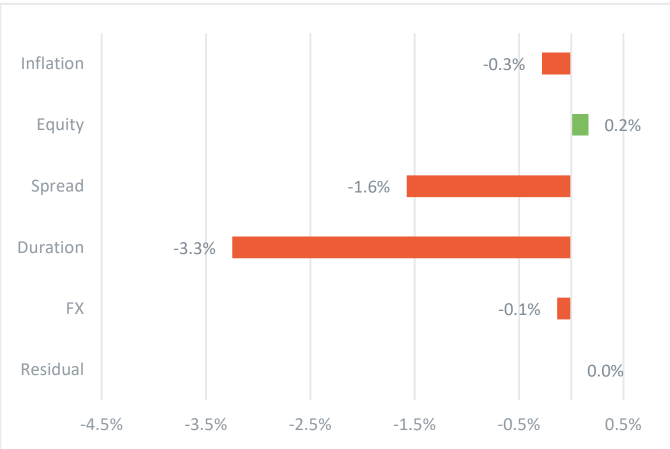
Importantly, the increase in duration happened predominantly at the short end of the yield curve. Short-dated government bond yields repriced significantly and are now offering a better risk-reward, in our view. US Treasury five-year bond yields are now close to the highest level they have been in 10 years, and we think they are offering a decent cushion for further volatility.

On the other hand, long-dated government bond yields are still historically low and we believe they can be subject to big reprices, particularly when the US Federal Reserve starts to shrink its balance sheet. We have a net short duration positioning in long-dated government bonds and we believe this can help the performance of the fund going forward, particularly if inflation remains elevated and central banks start reducing their balance sheets, as we expect them to do (see Figure 1).

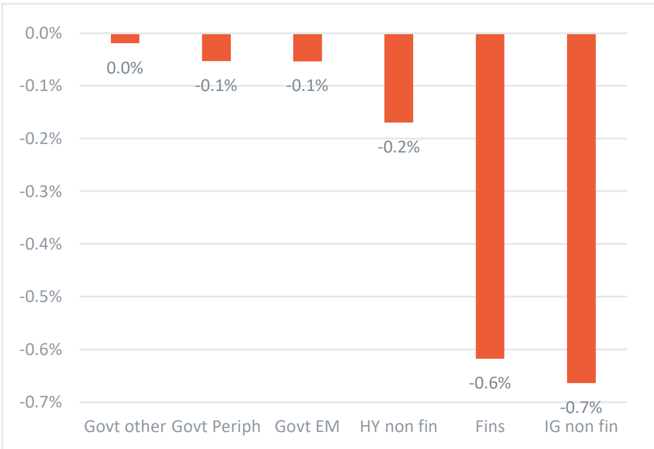
Figure 2: Absolute performance (gross of fees)

YTD Performance contribution

Total gross performance = **-5.1%**



Spread performance by asset class



Past performance is not a guide to future performance.

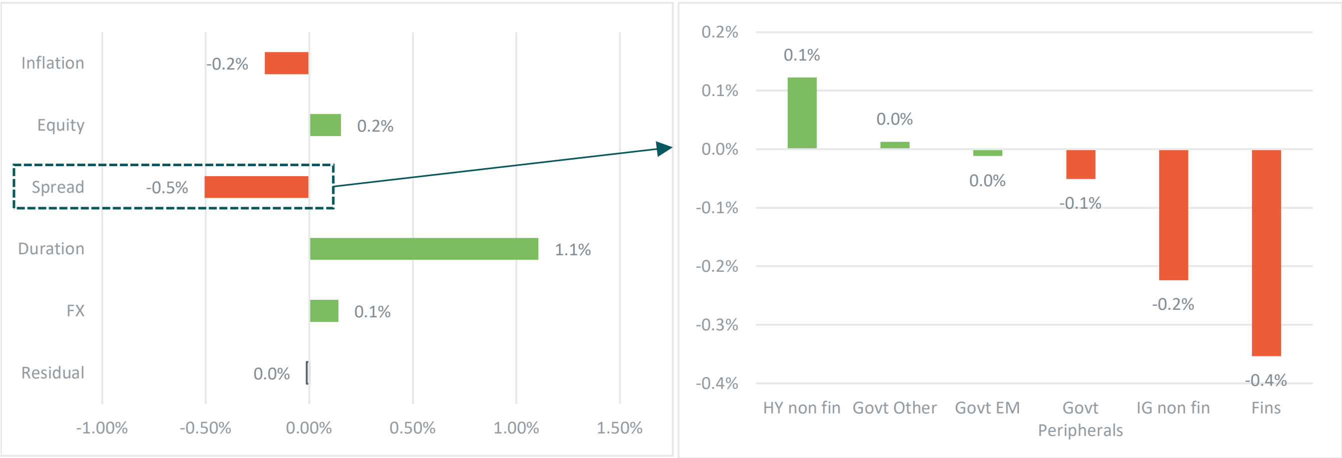
Source: M&G, 31 March 2022. Please note, portfolio data is based on internal sources and is unaudited.

Figure 3: Relative performance (gross of fees)

YTD performance attribution vs benchmark*

Total gross performance = **+0.7%**

Spread performance by asset class



Past performance is not a guide for future performance.

Source: M&G, 31 March 2022. Please note, portfolio data is based on internal sources and is unaudited.

*Benchmark = composite index comprising 1/3 Bloomberg Global Aggregate Corporate Index EUR Hedged, 1/3 Bloomberg Global High Yield Index EUR Hedged, 1/3 Bloomberg Global Treasury Index EUR Hedged. The benchmark is a comparator used solely to measure the fund's performance and reflects the scope of the fund's investment policy but does not constrain portfolio construction. The fund is actively managed. The fund's holdings may deviate significantly from the benchmark's constituents. The benchmark is not an ESG benchmark and is not consistent with the ESG Criteria.

Performance review

A combination of rising government bond yields and wider credit spreads has resulted in negative performance for most fixed income asset classes year-to-date. As of the end of March, the global investment grade index was down -7.1%, global high yield was -5.5% and the global government index was -4.7%[1].

Within the fund, exposure to credit risk has detracted as spreads have widened. In fact, most of the negative performance has come from investment grade bonds as this is the area where we continue to be most overweight (at around 44% of total fund assets).

Exposure to high yield bonds has also detracted this year, however contribution relative to the reference index was positive because we were underweight (see Figure 2 & 3).

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.

Duration was also a negative contributor, as yields rose. However our defensive duration positioning has helped us to outperform the benchmark so far this year.

Finally, returns from equities, which mainly come from companies with low price-to-earnings ratios, have contributed positively both in absolute and relative terms.

Going forward

We believe the combination of rising interest rates and widening spreads has resulted in a greater cushion than a few months ago for fixed income investors with long-term investment horizons. Many European government bonds now have a positive yield, while European investment grade companies currently offer a yield close to 1.6% and high yield bonds on average have a yield of 4.5%.

In this context and as a result of the changes we have made to the fund's portfolio, the M&G (Lux) Optimal Income Fund has also seen its cushion increasing. The fund offered a yield to expected maturity (essentially, an estimate of the annualised return until the expected maturity of its underlying holdings) of 2.95%, gross of fees, at the end of March. It was 0.87% one year ago.

In our opinion, the yield to maturity, while not perfect, may provide a useful starting point to think about future

[1] Euro hedged, Bloomberg data as at 31 March 2022.

Figure 4: Total return under various rate/spread scenarios based on current positioning

Table 1: Assumes parallel yield curve shift

Credit spreads

Government bond yields (assuming parallel yield curve shift)	-2.0%	-1.0%	No change	+1.0%	+2.0%
-2.0%	21.9%	16.3%	10.7%	5.1%	-0.5%
-1.0%	18.0%	12.4%	6.8%	1.2%	-4.4%
No change	14.2%	8.6%	3.0%	-2.7%	-8.3%
+1.0%	10.3%	4.7%	-0.9%	-6.5%	-12.1%
+2.0%	6.4%	0.8%	-4.8%	-13.9%	-16.0%

For illustration purposes only. This is not intended to provide expectations of future returns or yield and spread levels. Portfolio analysis based on a one-year holding period, assuming a static portfolio and parallel shifts in yield curves; excludes any exposure to equities. Analysis also assumes that any moves in rates and/or spreads are one-off shocks.

Table 2: Assumes 1% yield curve steepening

Credit spreads

Government bond yields (assuming 1% yield curve steepening)	-2.0%	-1.0%	No change	+1.0%	+2.0%
-2.0%	25.2%	19.6%	14.0%	8.4%	2.8%
-1.0%	21.4%	15.8%	10.2%	4.6%	-1.0%
No change	17.4%	11.8%	6.2%	0.5%	-5.1%
+1.0%	13.1%	7.5%	1.9%	-3.8%	-9.4%
+2.0%	8.5%	2.9%	-2.7%	-8.3%	-13.9%

For illustration purposes only. This is not intended to provide expectations of future returns or yield and spread levels. Portfolio analysis based on a one-year holding period, assuming a static portfolio and +100bp shifts in yield curves; excludes any exposure to equities. Analysis also assumes that any moves in rates and/or spreads are one-off shocks.

Source: M&G, based on fund and index positioning, 31 March 2022.

returns. If there are no changes in positioning and in market valuations, investors can expect a gross return broadly in line with the yield of the portfolio (3.0%).

However, markets are not static. They tend to be volatile and as a result performance usually differs from the yield to maturity. In Figure 4 we show how the fund could perform under different rates and spreads scenarios, based on the current fund positioning.

Based on our macro view and where valuations are, we are currently positioned for an environment of tighter credit spreads and rising government bond yields.

It is important to note that the fund is positioned for a steepening of the yield curve (see Table 2 in Figure 4). We take most of our duration at the front end, while we have a negative exposure at the long end of the curve. Figure 4 shows how the portfolio could perform under different scenarios, with Table 1 assuming a parallel yield curve shift and Table 2 a 100bps steepening of the yield curve.

YTD, YTQ (%) and 10- calendar year performance (pa%)

	2022 YTD	YTQ	2021	2020	2019	2018
Fund (EUR)	-5.2	-5.2	1.2	1.4	6.8	-4.0
BM* (EUR)	-5.7	-5.7	-0.9	5.0	7.8	n/a
Fund (USD)	-5.0	-5.0	2.0	3.1	9.9	-1.2
BM* (USD)	-5.5	-5.5	0.0	6.5	11.0	n/a
	2017	2016	2015	2014	2013	2012
Fund (EUR)	4.3	7.0	-1.6	4.7	7.2	13.0
BM* (EUR)	n/a	n/a	n/a	n/a	n/a	n/a
Fund (USD)	6.5	7.9	-1.2	4.9	7.3	13.5
BM* (USD)	n/a	n/a	n/a	n/a	n/a	n/a

YTQ = year to most recent quarter.

*Benchmark: 1/3 Bloomberg Global Aggregate Corporate Index EUR Hedged, 1/3 Bloomberg Global High Yield Index EUR Hedged, 1/3 Bloomberg Global Treasury Index EUR Hedged.
The composite index was introduced as the fund's benchmark on 7 September 2018. Fund performance prior to 7 September 2018 is that of the equivalent UK-authorised OEIC, which merged into this fund on 8 March 2019. Tax rates and charges may differ.
Source: Morningstar, Inc., as at 31 March 2022, Euro Class A Acc shares and USD Class A-Hedged shares, price-to-price, income reinvested. Not all share classes are registered for sale in all countries. Details in Prospectus.

Other important information

- The fund makes extensive use of derivatives.
- Investing in this fund means acquiring units or shares in a fund, and not in a given underlying asset such as a building or shares of a company, as these are only the underlying assets owned by the fund.

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

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