M&G (Lux) Optimal Income Fund

Investment update and outlook

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July 2022

- It has been a volatile first half of the year for markets and fixed income asset classes have produced a negative return.
- Rising inflation and international events have driven uncertainty and a diminished appetite for bonds.
- Based on our macro view and where valuations are, we believe the fund can benefit from tighter credit spreads and a steepening of the yield curve.
- Year-to-date, the fund has generated a negative return driven by wider spreads and rising government bond yields. However, the fund outperformed its benchmark year to date mainly thanks to its lower duration exposure and its exposure to value stocks.
- Duration is currently at around 5.1 years – the highest level in over 10 years. Most of the duration comes from the short and mid part of the curve while we retain a negative duration at the longer 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.

Market update

Financial markets have remained very volatile as we enter the second half of 2022. Investors' appetite for bonds had already been poor because of accelerating inflation and central bank interest rate hikes. International political developments have weighed even further on market sentiment. Despite this, we have remained reasonably constructive on the economy and this is integral to our portfolio positioning as we head through the remaining months of a challenging year.

The economy

We believe the economy is fine (albeit slowing) and the market is being somewhat over-sensitive. We also think central banks will at some point start to shift their attention from fighting inflation to preserving growth (please see our recent *Bond Vigilantes* blog, 'Top Gun - What is Powell's call sign?'). We suggest the central bank shift, from targeting inflation to avoiding recession and protecting jobs, could actually be beneficial for the fund's positioning.

There are clear challenges in the economy, with inflation being the main one. Any hope that US inflation may be peaking were dashed as a bleak US inflation report showed price rises accelerating in May. The headline annual rate came in at 8.6%, up from the 8.3% seen in April, and above most forecasts. The increase was primarily driven by higher food and fuel prices, but there were also significant contributions from shelter (housing rents) and other areas, suggesting that inflation in the world's largest economy was becoming even more broad-based.

There has been no let-up in the pace of inflation in the UK either, with the annual rate reaching 9.1% according to the latest data, and the Bank of England warning that price rises are likely to hit 11% by this autumn.

On the upside, both consumers and companies are in a solid financial position and wages are rising, helping to offset some of the inflation pressure. As a result, we believe bond default rates are unlikely to increase as much as the market is currently pricing in and this makes us more comfortable to own credit.

Portfolio positioning

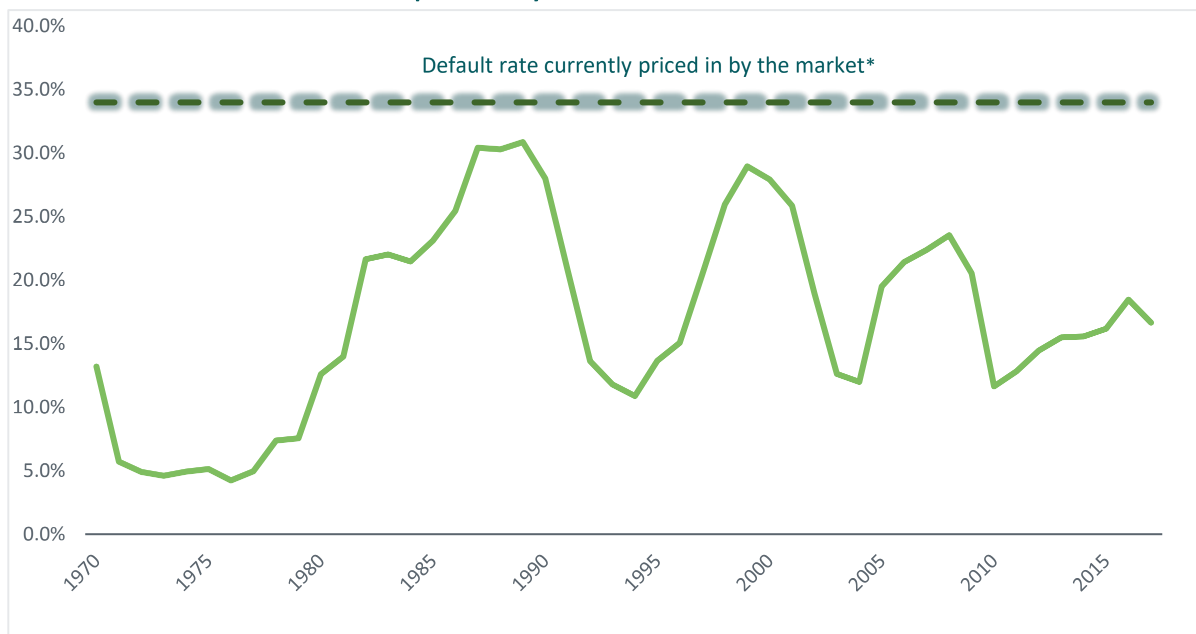
While credit spreads have experienced high volatility in the first half of the year, we do not think the risk of default has materially changed. We also believe long-term investors are currently being compensated to take credit risk.

Figure 1, overleaf, shows what level of default is currently priced into the high yield bond market versus what historically has been the *actual* default rate for this market. Spreads are suggesting that about one third of the high yield bond market will default over the next five years. Historically we have never experienced more than 30% defaults over any five-year period. As a result, we maintain a positive view on credit and expect spreads to tighten in the coming period.

Figure 1: Currently, you are getting paid to take credit risk

Past performance is not a guide for future performance.

Historical HY default rate vs what is priced in by the market



Source: M&G, Deutsche Bank, ICE Bank of America, Moody's Research, 30 June 2022. *Calculated using the 5y CDX HY index and assuming a recovery rate of 30%.

Typically, at least 50% of the portfolio is invested in a broad range of fixed income securities of any credit quality and from any country, including emerging markets, and denominated in any currency. The manager may also hold up to 20% of the portfolio in equities. The fund follows a positive ESG tilt approach, achieved by the fund maintaining a weighted average ESG rating above that of the benchmark.

Some changes within our asset allocation during the first half of 2022 include:

- We have added **high yield bonds** exposure mainly through the derivatives market, and added some **financial bonds** because we believe banks, for instance, could well benefit from an environment of rising interest rates. Meanwhile, high yield should remain supported in an environment of positive economic growth.
- We have been active in the primary market for **investment grade credit**, arguing a delay in issuances has resulted in price dislocations (a high new issue premium).
- We remain cautious in areas of the market that have been most affected by quantitative easing in recent years. As central banks start to reduce their balance sheets, these bonds will likely come under pressure.
- Overall, there is still plenty of room to add credit risk if spreads widen further (not our base-case view).

Liquidity in the portfolio remains relatively high with a combined c26% in cash and risk-free government bonds.

- Figure 2 shows the direction of some of our key investment positions during the period from 1 January 2022 to 30 June 2022. Where we position the fund relative to duration is a key view of ours.

Figure 2: Key changes in fund portfolio positioning over the first six months of 2022

	Start of 2022		30 June 2022
Duration	2.4 years	↑	**5.1 years**
Investment grade credit	45%	↑	**47%**
High yield bonds	22%	↑	**35%**
Government bonds	23%	↑	**25%**
Equities	5.5%	↓	**1.7%**

Source: M&G. Portfolio positioning for the M&G (Lux) Optimal Income Fund at 31 January 2022 versus 30 June 2022.

Duration

An important 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 have effectively doubled our rate sensitivity from 2.4 years to 5.1 years duration. Our benchmark has 6.5 years of duration.

The increase in duration has happened predominantly at the short and middle end of the yield curve. We believe these bonds are now offering a better risk/reward and pricing in several rate hikes. Most of the duration comes from US dollar and euro rates as this is where the market is already pricing in different rate hikes. Conversely, we have a low duration in sterling assets and a negative duration in Japanese bonds.

On the other hand, long-dated government bond yields are still historically low, and we believe they can be subject to big re-prices, particularly as the US Federal Reserve is shrinking 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.

Equities

Our equity allocation, which is predominantly made of low price-to-earnings companies, has performed relatively well this year. As a result, the yield differential between the equities we own and bonds has generally compressed, pushing us to reduce our allocation to stocks that performed well and gradually moving back into bonds. Exposure, as a percentage of total fund assets, is now below 2% and over half what it was at the start of the year.

Performance review H1 2022

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.

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, as mentioned.

Exposure to high yield bonds has also detracted this year, although contribution relative to the benchmark index was positive because we were underweight.

Duration was also a negative contributor, as yields have risen. However, our defensive duration positioning has helped us in relative terms on many occasions.

Finally, returns from equities, which mainly come from companies with low price-to-earnings ratios, have been positive.

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.

Going forward

We believe the combination of rising interest rates and widening spreads has resulted in a greater cushion than at the start of the year for fixed income investors with long-term investment horizons.

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 3.96%, gross of fees, at the end of June. It was 1.69% at the start of the year.

In our opinion, the yield to maturity, while not perfect, may provide a useful starting point to think about future returns. If there are no changes in positioning nor in market valuations, investors can expect a gross return broadly in line with the yield of the portfolio (c3%).

However, markets are not static. They tend to be volatile and as a result performance usually differs from the yield to maturity. In Figure 3, 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 no big changes to government bond yields (although we do still expect some pressure at the long end of the curve, where we currently have a negative exposure).

Figure 3: How the fund *might* perform over the next 12 months?

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

Credit spreads (columns); Government bond yields (rows)

Government bond yields	-3%	-2%	-1%	No change	1%	2%	3%
-1.50%	29.2%	23.3%	17.5%	11.6%	5.8%	-0.1%	-5.9%
-1.00%	26.6%	20.8%	14.9%	9.1%	3.2%	-2.6%	-8.5%
No change	21.5%	15.7%	9.8%	4.0%	-1.9%	-7.7%	-13.6%
1.00%	16.4%	10.6%	4.7%	-1.2%	-7.0%	-12.9%	-18.7%
1.50%	13.9%	8.0%	2.2%	-3.7%	-9.6%	-15.4%	-21.3%

For illustrative 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.
Source: M&G, based on fund and index positioning, 30 June 2022.

Figure 4; YTD, YTQ (%) and calendar-year performance (pa%)

Past performance is not a guide to future performance.

	2022 YTD	YTQ	2021	2020	2019	2018
Fund (EUR)	-12.7	-7.9	1.2	1.4	6.8	-4.0
BM* (EUR)	-13.0	-7.7	-0.9	5.0	7.8	n/a
Fund (USD)	-12.0	-7.4	2.0	3.1	9.9	-1.2
BM* (USD)	-12.1	-7.0	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.

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.

Source: Morningstar, Inc., as at 30 June 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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