The importance of flexibility

The M&G (Lux) Episode Macro Fund

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- So far in 2022, returns from many major asset classes have declined against a background of rising interest rates.
- The M&G (Lux) Episode Macro Fund is one of M&G's most flexible and dynamic funds, with the freedom to take long and short positions (which seek to take advantage of a fall in the price of a security) in different types of assets from anywhere in the world.
- The ability to initiate short bond and currency exposures has helped the fund to generate positive returns so far this year, and over both the past three and five years.

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.

Few places to hide

Last year we noted how the implied returns of many major asset classes were at historic lows ('Active asset allocation more important than ever,' February 2021). At that point we suggested that investors would need to make use of new approaches if they were to generate returns similar to those they had enjoyed in recent decades.

The vulnerability of major assets has been revealed quickly, with many declining sharply so far this year. Some global bond indices, which offered low yields (and therefore high prices) five years ago, are now delivering negative nominal returns over five years.

Figure 1. Returns from various asset classes

Asset class	YTD 2022	1 year	3 yrs (pa)	5yrs (pa)
Global equity	-13.2	-4.4	9.3	8.9
Corporate bonds	-12.2	-12.8	-3.5	-1.3
Inflation-linked bonds	-3.9	-0.5	1.4	1.4
Global convertibles (hedged)	-17.1	-19.2	-0.4	-0.2

Past performance is not a guide to future performance

Source: Morningstar, as at 30 June 22. Returns in euro terms. Global equity is measure by the MSCI ACWI Index, corporate bonds by the Morningstar EUR Corporate Bond Sector, inflation-linked bonds by the Morningstar EUR Inflation-Linked Bond Sector Average, and convertibles by the Morningstar Convertible Bond - Global, EUR Hedged Sector.

Inflation and rising real interest rates are the challenge

Correlated shorter-term price weakness across assets is not something investors have had to deal with for much of the recent past. In a world in which real (inflation-adjusted) interest rates had generally been declining while inflation remained stable, most assets enjoyed tailwinds. Generally, bonds had the ability to offer diversification from riskier assets in periods of growth disappointment.

But as 2022 has demonstrated, inflationary pressures and rising real interest rates challenge this dynamic, threatening correlated weakness across most assets. This pressure is not only felt through reductions in valuation. When central banks are forced to raise interest rates and cut purchases of assets from the markets in response to inflation, this could also hit businesses' profits growth, putting downward pressure on the valuations of company shares (equities) and of other assets that are considered riskier.

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Valuation is paramount

The M&G (Lux) Episode Macro Fund can take both long and short positions in equities, fixed income (bonds), currencies, credit (corporate bonds) and other assets, across both developed and emerging markets. The approach rests upon a combination of longer-term assessments of prospective returns and tactical responses to 'episodes' of near term volatility. (We classify episodes as instances when asset price volatility seems to be at odds with changes in what we see as the asset's underlying fundamentals.)

As such, the fund can adopt short exposures when valuations suggest that assets are over-priced and vulnerable to changing economic conditions. This has, in our opinion, been the case over the past 12 months. Short positions in developed market government bonds and US equities have been an important part of return generation and volatility management for the fund.

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. Investing in emerging markets involves a greater risk of loss as there may be difficulties in buying, selling, safekeeping or valuing investments in such countries.

Tactical responses to volatility

The second key element behind the fund's investment approach is seeking to generate returns from short-term volatility. In an environment of rising interest rates, in which the implied buy-and-hold returns on many assets appear less attractive, such dynamism is likely, in our view, to be an increasingly important driver for performance.

Over the course of 2022 to date, we have taken tactical decisions in response to the volatility displayed by markets. During this period equity exposure has ranged between net long exposure of 35% and 11%, including periodically holding 15% short exposure to the US market. The fund has been both long and short of bonds over the past three years.

The fund may be highly concentrated at times in a limited number of investments or areas of the market, which could result in large price rises and falls. The fund can be exposed to different currencies. Movements in currency exchange rates may adversely affect the value of your investment.

Investment decisions are made from a top-down perspective, analysing macroeconomic trends, and typically expressed via highly liquid country or sector level derivative instruments (whose value depends on that of an underlying asset such as a stock or bond). This approach has been employed since the late 1990s, being used by a range of investors as a macro strategy in its own right, a portfolio diversifier, as well as an asset allocation 'overlay' within portfolios.

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.

In our experience, the volatility seen this year is often a feature of conditions in which one economic environment, or 'regime,' gives way to another.

Is the regime changing?

Consensus expectations are for inflationary pressures to subside in the near-term as supply side issues are resolved, although there are signs that a more pronounced regime shift for investors is emerging.

Recent signs of upward pressure on wages and service sector price inflation are part of this, but more significant for investors are potential challenges to financial markets over a sustained period.

Ongoing 'de-globalisation and 'onshoring,' a political shift in favour of labour versus capital, demographic trends, and the costs to companies and governments of ESG (environmental, social and governance) policies, all represent very real challenges to the supportive environment that markets have enjoyed since the 1980s.

Has value been restored?

The sell-offs have already resulted in sharp increases in yields (and corresponding falls in prices) on many longer-dated fixed income assets, as well as a widening in credit spreads (difference between yields on 'safe haven' government bonds and riskier corporate bonds) and a notable fall in valuation of equity markets over the course of 2022.

This suggests a far healthier situation than this time last year, and implies the potential of reasonable returns if the next 10 years were to look like the last 10. However, if the regime is changing and the potential threats noted above come to pass, current valuations are unlikely to be sufficient to offset the headwinds faced by investors.

Conclusion

The investment landscape of the last six months has been starkly different to that of much of the last two decades.

Over the past 20 years or more traditional and passive 'buy and hold' approaches to multi asset have been sufficient to deliver satisfactory returns to most investors.

It remains to be seen whether the future looks more like the new regime seen this year, reverts to the past regime, or indeed brings something totally different. However, our approach has been tested across a variety of different regimes since the late 1990s.

Sticking to the episode strategy's combination of flexibility, long-term value assessment, and willingness to seek opportunity amidst volatility will remain key as the fund continues to target a total return 4-8% a year above the Secured Overnight Financing Rate (SOFR), over any five-year period.

Fund performance 5-year fund performance (%, pa)

	YTQ*	YTD	1yr	3yr pa	5yr pa
EUR S-H Acc	10.4	10.4	7.8	5.5	3.0
Benchmark (EUR)**	1.7	1.7	3.4	3.5	3.5
USD S Acc	11.1	11.1	9.1	7.1	5.2
Benchmark*** (USD)	2.2	2.2	4.2	4.7	5.3

Past performance is not a guide to future performance.

Source: Morningstar Inc., 30 June 2022, EUR S-H and USD S share classes, income reinvested, price to price.

* YTQ = year to the most recent quarter-end (Q2)

** **Benchmark (EUR)** = ESTR +4-8%

*** **Benchmark (USD)** = SOFR + 4-8%

Prior to 3 August 2021 the benchmark for the fund's EUR-denominated share classes was 3-month EUR LIBOR + 4-8%. With effect from 3 August 2021 the benchmark is ESTR + 4-8%. For the USD-denominated share classes, the benchmark was 3-month USD LIBOR + 4-8%; it is now SOFR + 4-8%.

The benchmark is a target which the fund seeks to achieve. The rate has been chosen as the fund's benchmark as it is an achievable performance target and 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 assets to buy, hold and sell in the fund.

Fund performance prior to 26 October 2018 refers to the UK-authorised OEIC, which merged into the M&G (Lux) Episode Macro Fund (a Luxembourg-authorised SICAV) on 26 October 2018. Tax rates and charges may differ.

Discrete-year performance, 10 years (pa, %)

	2021	2020	2019	2018	2017
Fund (EUR)	-4.1	6.1	11.0	-10.3	7.7
Bmark (EUR)	3.4	3.6	3.6	3.6	3.6
Fund (USD)	-3.2	7.7	14.6	-7.4	10.0
Bmark (USD)	4.1	4.7	6.5	6.5	5.3
	2016	**2015**	**2014**	**2013**	**2012**
Fund (EUR)	8.9	1.4	10.0	6.4	-6.1
Bmark (EUR)	3.7	4.0	4.2	4.2	4.5
Fund (USD)	9.9	2.3	9.8	6.5	-5.4
Bmark (USD)	4.8	4.3	4.2	4.3	4.5

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Source: Morningstar Inc., 30 June 2022, EUR S-H and USD S share classes, income reinvested, price to price.

The fund allows for the 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.

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

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