M&G (Lux) Optimal Income Fund

A dynamic and flexible approach across fixed income

September 2022

- Richard Woolnough's aim to purchase those assets that provide the most attractive, or 'optimal', income stream for the fund is what inspired the name of the M&G (Lux) Optimal Income Fund.
- The fund's unconstrained approach gives the manager the possibility to move freely between government bonds and investment grade as well as high yield corporate bonds. He can also invest in equities when a company's shares appear more attractive than its debt.
- The fund is actively managed by combining a top-down macroeconomic analysis approach with rigorous bottom-up credit analysis. The manager's preferences for exposure to interest rate risk (duration) and corporate bonds risk (credit) will depend on his outlook for interest rates, economic growth and inflation.

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.

What is your macro view currently?

Financial markets have remained very volatile as we enter the final months 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.

Can you provide some insight into asset allocation?

The fund aims to provide a combination of capital growth and income to deliver a return based on exposure to optimal income streams in investment markets. 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, and denominated in any currency. The fund manager selects investments wherever he sees the greatest opportunities, based on his assessment of a combination of macroeconomic, asset, sector and stock-level factors. We may also hold up to 20% of the portfolio in equities. A neutral position for this strategy would be 1/3 global government bonds, 1/3 global corporate bonds and 1/3 global high yield bonds.

The fund follows a positive ESG tilt approach, achieved by maintaining a weighted average ESG rating above that of the benchmark. The fund also excludes any company that is assessed to be in breach of the United Nations Global Compact principles and any government bond from countries classed as "Not Free" by the Freedom House Index. The fund may gain exposure to assets through both physical holdings and the use of derivatives.

What about recent fund positioning?

The biggest change so far this year has been to increase the duration of the portfolio. We were significantly underweight at the start of the year. As yields sold off we have been adding duration back and we are now closer to neutral.

Meanwhile, we remain constructive on credit (as corporate bonds are also known) as we don't think the economy is as weak as the market seems to imply. Within credit we have been adding mainly to financial bonds and high yield bonds. The former is an area that tends to benefit from rising interest rates and, in our view, has not been directly impacted by quantitative easing, as central banks have focused their asset purchases on non-financial bonds. High yield is also an area that we favour as we consider the default rates – meaning, non-payment of interest or of the principal -- will not increase as much as expected by the market. Please see Figure 1 (overleaf) for further details of asset allocation to the end of August 2022.

Figure 1: Key changes in fund portfolio positioning over 2022

	Start of 2022		31 August 2022	
Duration	2.4 years	↑	**5.1 years**	*Extended as yields rise, which we see as a buying opportunity.*
Investment grade corporate bonds	45%	↑	**45%**	*While improving valuations have recently introduced some opportunities, exposure is about the same as the start of the year.*
High yield bonds	22%	↑	**33.8%**	*Increased as we think they have become more attractive based on default rates.*
Government bonds	23%	↓	**22.6%**	*Drifted slightly lower.*
Equities	5.5%	↓	**0.3%**	*Reduced significantly as we believe the bonds of a company are currently better value than its shares.*

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

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.

Interest rate risk – How is this important for the fund?

Our opinion on duration, in addition to corporate credit, is very important in how we position the fund. As highlighted above, an important change we have carried out to the portfolio so far this year has been in our positioning towards interest rate sensitivity. Given the move higher in government bond yields, we have been adding duration back. So far this year we have effectively doubled our interest rate sensitivity from 2.4 years to 5.1 years duration. Our benchmark has 6.2 years of duration.

How has performance been this year?

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. 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. (Please see Figure 2 *Performance* table, overleaf).

Going forward

While the economy is clearly slowing down, we argue that a recession (particularly in the US) is not as imminent as the market implies. The labour market is strong and households are in a good financial position, in our opinion. Going forward most will depend on what central banks will decide to do – how aggressive will they be with rate hikes in light of an uncertain inflation/economic growth dynamic?

The good news for credit investors is that most of the bad news is already contained in the price, in our view. Spreads are almost historically wide and in some areas are very close to where they were during the COVID-19 induced recession. The market is already pricing in a scenario where around a third of the high yield bond market will default over the next five years. While this is not impossible, it is worth noting that it has never happened before. Also, we have just come out from a recession (COVID-induced) and most weak companies have already defaulted. In our opinion, we are left today with a stronger cohort of companies, which suggests to us the risk of very high defaults is low.

Finally, credit investors can also take some comfort from the overall yield that fixed income markets are currently offering. So far this year, both spreads and rates repriced wider and this has pushed the overall yield to a 10-year high. This level of yield, while not preventing short-term volatility, can provide a good cushion for long-term investors, in our view.

Currently the fund has a yield-to-worst of 4.25% (as at the end of August 2022; the yield-to-worst is calculated in fund base currency, gross of fees, as the worst possible outcome by using various call dates for the bonds held by the fund).

Figure 2: Performance: YTD, YTQ (%) and calendar-year performance (pa%)

	2022 YTD	YTQ	2021	2020	2019	2018
Fund (EUR)	-12.0	-7.9	1.2	1.4	6.8	-4.0
BM* (EUR)	-12.4	-7.7	-0.9	5.0	7.8	n/a
Fund (USD)	-11.0	-7.4	2.0	3.1	9.9	-1.2
BM* (USD)	-11.2	-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 31 August 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 key fund risks

- 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.
- 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.
- ESG information from third-party data providers may be incomplete, inaccurate or unavailable. There is a risk that the investment manager may incorrectly assess a security or issuer, resulting in the incorrect inclusion or exclusion of a security in the portfolio of the fund.
- Further details of the risks that apply to the fund can be found in the fund's 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.

- For an explanation of technical terms, please refer to the glossary via the link: https://www.mandg.com/dam/global/shared/en/documents/glossary-master-en.pdf

For European investors, the fund's sustainability-related disclosures can be found on the relevant country website below:

Luxembourg:
https://www.mandg.com/investments/professionalinvestor/en-lu/funds/mg-lux-optimal-incomefund/lu1670724373#sust

Austria:
https://www.mandg.com/investments/professionalinvestor/de-at/funds/mg-lux-optimal-incomefund/lu1670724373#sust

Belgium:
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France:
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Germany:
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Greece:
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Liechtenstein:
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Netherlands:
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Norway:
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Portugal:
https://www.mandg.com/investments/privateinvestor/pt-pt/solucoes/os-nosso-fundos

Spain:
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M&G Investments