M&G (Lux) Optimal Income Fund

Fixed income in a yield-rising environment – Richard Woolnough, fund manager.

October 2022

- In an environment where macroeconomic uncertainty remains elevated, we believe fixed income can provide investors with an attractive alternative to efficiently manage their portfolios.
- The recent surge in inflation has pushed central banks to hike rates aggressively - we now believe the level of bond yield today is making the asset class good value.
- As market volatility has increased, utilising the fund's unconstrained approach has come to the fore.

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.

Introduction

What a difference a year makes! It was not too long ago that fixed income markets were flirting with the "zero bound" range of interest rates and investors were in some cases required to pay to lend their money to governments and businesses. The amount of negative-yielding debt across the world peaked at US$18.0 trillion in 2020. Since then, a surge in inflation has pushed central banks to hike rates aggressively. Today the total amount of negative-yielding debt is close to disappearing as bond prices, which move inversely to yields, have collapsed.

Going from US$18.0 trillion all the way down to zero has been a very painful journey for fixed income investors, but we suggest the level of yield we have reached today makes this asset class look attractive to investors, who can now potentially achieve returns of around 5% without needing to take excessive risk. In an environment where macroeconomic uncertainty remains extremely elevated, we believe that fixed income can provide investors with a strong alternative to efficiently manage their portfolios.

Key changes to the portfolio

- **Increased duration to 5.9 years** – bond yields are the highest they have been in more than a decade and as a result our fund duration (sensitivity to interest rate changes) is now the highest since 2008, and the global financial crisis. For the first time in a long time we now generally find government bonds 'fair value', however we still think the long-end of the yield curve is expensive.
- Adding to **high yield** and **financials** - as credit spreads (the difference between government bond yields and corporate bond yields, which give a measure of the market's appetite for risk) widen we have been looking for opportunities to add credit risk. We have added risk mainly in high yield bonds and financial bonds (banks, insurers etc). The former is already discounting a severe default cycle, which is not our base case scenario. The latter will likely benefit from an environment of rising rates.
- Reducing **equity** - we have reduced exposure to company shares, from around 5.5% at the start of the year to around 0.3% today. We believe owning company debt is now generally more attractive than owning company shares. The reduction was further accentuated by the performance of our equity basket: we mainly held value stocks, which strongly outperformed bonds.

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

Our key investment convictions

1) **There is now value in fixed income**
For the first time in a decade we now believe bonds are good value, both in absolute and relative terms. Many government bonds are now paying positive real rates across different countries, while credit spreads are already discounting a severe default cycle – not our base case view. Moreover, the sharp repricing experienced this year in most bond markets has resulted in some types of bonds now yielding more than certain stocks. We argue this makes the asset class a valuable alternative for investors, currently.

2) **Long-term government bonds are still expensive**
While we find the middle part of the yield curve fair value, we still believe the long end is more expensive. Investors want to be compensated for the extra uncertainty of lending long term (also known as the term premium) but that is not the case today. The yield curve (which shows yields along the maturities of various bonds) is flat and the term premium is still negative. Long-dated bonds could also suffer from central banks reducing their balance sheets as they have purchased these bonds in large volumes.

3) **Favouring financials as yields rise**
Our team of credit analysts currently see banks as an attractive option – the competitive price of these bonds reflects a strong perception from many in the market that they will suffer heavy losses as the global economy slows. We actually believe that market perception is some distance away from the fundamental picture. While some losses will clearly occur, in our opinion the reality is that the vast majority of large banks are in good shape to weather such storms and the increase in interest rates could significantly improve their profitability. Moreover, banks have not been directly impacted by quantitative easing, as central banks have focused their asset purchases on non-financial bonds. All things remaining equal, banks should therefore not suffer from central banks' ongoing quantitative tightening this year, in our view.

Figure 1: Key changes in fund portfolio positioning over 2022

	Start of 2022		30 September 2022	
Duration	2.4 years	↑	**5.9 years**	*Extended as yields rise, which we see as a trading opportunity eg short tactical buying of UK gilts 2050/2051.*
Investment grade corporate bonds	45.6%	↓	**41.6%**	*The recent volatility in markets allowed us to make a few relative value trades, but we are being careful and selective here.*
High yield bonds	22.1%	↑	**35.6%**	*Above neutral weighting (33%) as the team continues to see attractive valuations relative to predicted default rates.*
Government bonds	23.6%	↑	**24.3%**	*Drifted slightly higher – but we are seeing some 'fair value' in certain sovereign markets and at certain maturities.*
Equities	5.5%	↓	**0.3%**	*Reduced this year 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 30 September 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.

Why consider an Optimal Income solution today?

- ✓ **A diversified product with an attractive yield**: in times of uncertainty, diversification is crucial. We believe Optimal Income combines the best of the different fixed income worlds, providing investors with the potential for an attractive yield from a diversified portfolio. 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 5.36% (as at the end of September 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).

- ✓ **A flexible solution to navigate uncertain waters**: uncertainty and volatility often require a dynamic approach in order to capture the optimal income streams offered by financial markets. This is what the fund is designed to do – and is behind the fund's name. Over time, we have changed our allocation depending on where we are in the cycle. Looking back at some changes made in the original M&G Optimal Income Fund (the UK-domiciled fund launched December 2006), during **2008** we were defensively positioned, with little credit risk and high relative duration. As things started to improve we added back to credit risk, while reducing duration. In **2012**, just before former European Central Bank President Mario Draghi's now-famous "whatever it takes" commitment to support the integrity of the eurozone, we had our largest exposure to credit risk. Since then, credit performed very well and we moved more defensive, to the point where (just before the outbreak of the COVID pandemic) we had our lowest-ever exposure to high yield bonds, for example. In **2022**, as we think both credit and duration are becoming increasingly attractive, we have been adding to both areas.

- ✓ **An experienced team to help us identify opportunities**: by relying on the expertise of our credit analysts and other investment professionals, we can make full use of our flexibility and capture opportunities. This is particularly relevant today as things are moving fast and the macro picture remains uncertain. Moreover, central banks, with the exception of the Bank of England's recent UK gilts purchasing, are engaging in large reductions of their balance sheets (ie, selling bonds). We think this is bringing further volatility to the market and therefore even more opportunities for active fixed income investors with a long-term horizon. There are over 300 fixed income professionals working at M&G Investments today, including an extensive credit analyst department.

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

	2022 YTD	YTQ	2021	2020	2019	2018
Fund (EUR)	-16.9	-16.9	1.2	1.4	6.8	-4.0
BM* (EUR)	-16.1	-16.1	-0.9	5.0	7.8	n/a
Fund (USD)	-15.6	-15.6	2.0	3.1	9.9	-1.2
BM* (USD)	-14.7	-14.7	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 September 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.
- 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:

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