M&G (Lux) Optimal Income Fund

Investment update – Richard Woolnough, fund manager

February 2023

- The starting point for fixed income investors looks appealing against a backdrop of lower asset prices, with the compensation investors could receive greater compared to this time last year
- Fund duration remains close to neutral. We continue to see value in government bonds, but we also recognise interest rates must stay higher for longer
- Because of perceived attractive prices boosted by healthy fundamentals, the fund's exposure to financial bonds has increased - it has risen from 7% to 27% over the past two years
- Relative fund performance continues to be driven by the direction of the credit markets and tighter valuations between perceived safe government bonds and riskier corporate bonds

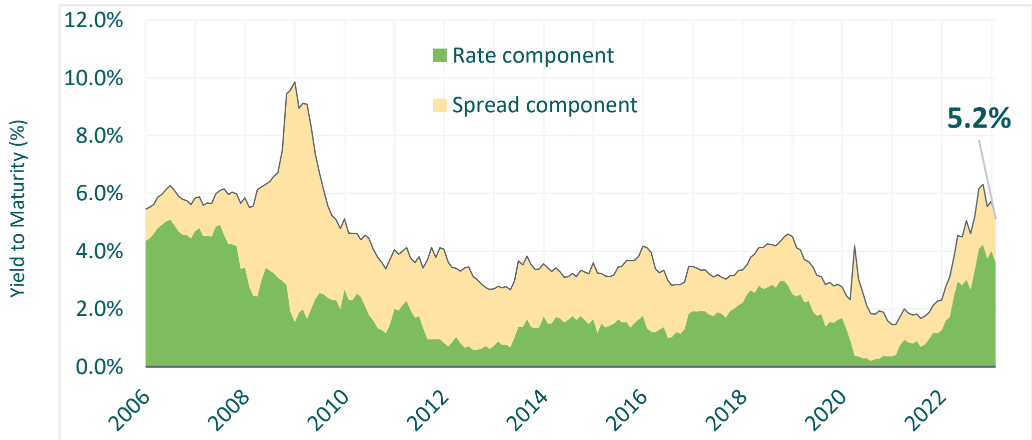
The value and income from the fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested.

Bond market valuations -- a strong starting point for 2023?

After a decade of zero or negative interest rates in developed markets, inflation has jumped and central banks have had to reverse course and hike interest rates aggressively. As a result, government and corporate bond yields have risen dramatically (and this means prices have fallen with a similar velocity). The starting point for fixed income investors is much stronger today than it was at the beginning of 2022, with both the interest rate and investment grade spread components of bonds providing what we see as an attractive carry.

Investors can now achieve a yield of 5.2% for investing in US investment grade (ie high quality) corporate bonds, the highest level since the global financial crisis. Please see Figure 1, below.

Figure 1. The yield on high quality corporate bonds issued by US companies is now at its highest point since 2009!



Past performance is not a guide to future performance.

Source: Bloomberg, 31 January 2023; Bank of America IG Corporate bond Index spread. The yield to maturity is made up of two components: the interest rate part (5-year US Treasuries) and the spread part (US investment grade corporate bond spread).

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

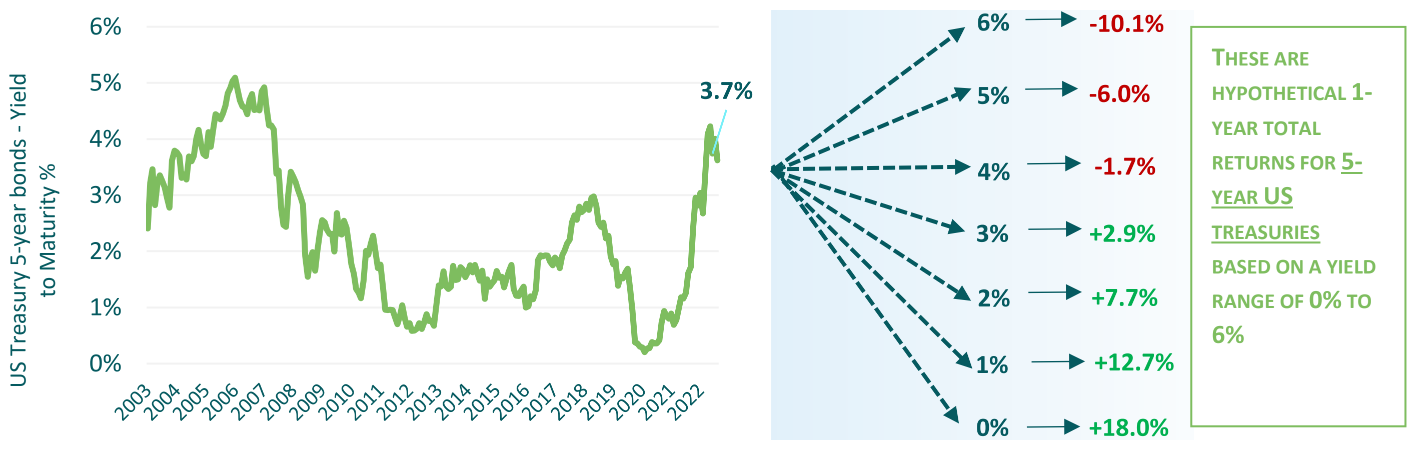
Key investment themes

- We remain constructive on the global economy and as a result we maintain an overweight exposure to credit. The M&G (Lux) Optimal Income Fund is currently invested in government bonds (26.9%), investment grade corporate bonds (41.3%), and high yield corporate bonds (34.7%). The fund's yield to maturity remains elevated, at 4.39% for the Euro Class A Acc share class, and 6.26% for the USD Class A-Hedged Acc share class. We consider this is a strong starting position to generate attractive levels of returns and income, even if we do still expects bouts of volatility in 2023-4.

- The risk-reward in five-year US Treasuries has improved: It took 10 months of US inflation above 5% (on a year-over-year basis) before the US Federal Reserve hiked interest rates for the first time in March 2022. The Fed has been playing catch-up ever since, and has hiked rates at breakneck speed while simultaneously reducing the size of its balance sheet. Given the lagged effects of tighter monetary policy, we now see inflation on a downward trajectory in the US and in many parts of the world. While our base case scenario is for interest rates to remain higher for longer, the current environment of higher government bond yields combined with declining inflation has improved the risk/reward profile of government bonds, in our view.

- We have also sought to take advantage of the improved outlook for government bonds to increase the duration of the fund over the course of the year, from 2.4 years in January 2022 to around 5.6 years (as at 31 January 2023). While this is not our base case scenario, should there be a significant downturn of the US economy in the coming months we believe US Treasuries could offer downside protection, as yields are likely to fall in that situation, generating attractive potential total returns for investors. Please see Figure 2, below.

Figure 2. We are of the opinion that the current environment has improved the risk/return reward profile of major government bonds. The example below shows five-year US Treasuries.



Past performance is not a guide to future performance.

Source: Bloomberg, as at 31 January 2023. Scenarios are an estimation and are not guaranteed. Information is subject to change and is not a guarantee of future results.

Portfolio update

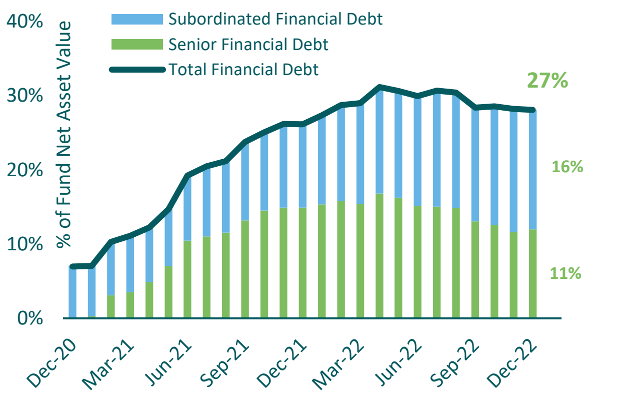
- As confidence returns to bonds, activity in the primary bond market has picked up. With plenty of deals coming to the market, we have been eager to participate and try to take advantage of what we consider attractive new issue premium offered by companies (eg Credit Agricole, Standard Chartered), with many operating in the financial sector.

- We continue to find dislocations across markets and have been active in relative value trades, particularly in the financial bonds space and between euro-denominated bonds and US dollar bonds. Our credit analyst team are continuing to identify what they think is historically attractive yield pick-up between the two types of bonds.

- As spreads have tightened during early 2023, we have taken some profits on strong performers. As a result, while we remain positive on credit, we have reduced our overweight.

- We continue to favour financial bonds. We believe that fundamentals are quite strong in banks -- they are well-capitalised and profitability has increased in the current environment of higher rates. Despite this positive backdrop, bank debt underperformed in 2022 as financial bond issuance has been stronger than in other sectors (eg, non-financial companies have refrained from issuing bonds given the increased cost of debt). As supply normalises across sectors, we think banks and financials could perform well and spreads could tighten back to more normal levels over time. Please see Figure 3, below.

Figure 3: Since 2020, fund exposure to financial bonds has increased from 7% to around 27% (total financial debt)



Source: M&G. Portfolio positioning for the M&G (Lux) Optimal Income Fund at 31 January 2023.

Figure 4: Key changes in fund portfolio positioning – last 12 months

	Start of 2022	Start of 2023	
Duration	2.4 years	5.6 years	Extended as yields rose in 2022 and close to a neutral bias of 6 years.
Investment grade corporate bonds	45.6%	41.3%	We are being careful and selective here and avoiding over-priced names. We've sold some on strong valuations. It's been a healthy primary market this year.
High yield bonds	22.1%	34.7%	Around neutral weighting (33%). We continue to see some attractive valuations relative to predicted high default rates.
Government bonds	23.6%	26.9%	We are seeing some 'fair value' in certain sovereign markets and at certain maturities. Some rotation out of US and UK assets into euro-based assets as the ECB continues to show more hawkish sentiment.
Equities	5.5%	0.3%	Reduced in last 12 months; 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 January 2023.

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.

Performance review

2022 – A challenging year!

Higher-than-expected inflation forced central banks to aggressively hike rates, increasing fears of an imminent recession. As a result, fixed income markets tumbled in 2022, driven by both duration (rising interest rates) and increasing default risks (rising spreads). The fund generated a negative return. This was mainly driven by rising rates, however it outperformed its reference benchmark thanks to the underweight duration positioning. Exposure to value equities also helped performance, while our more constructive view on credit generally detracted as spreads rose.

Year to date 2023 – A strong start

In contrast to an extremely challenging 2022, it has been a positive start in terms of the performance of fixed income markets and the fund (both in absolute and relative terms). At an asset class level, strong performance has been driven by a combination of slower rate rises and tighter spreads. At a fund level, performance has been driven by our credit exposure. Within credit, our higher allocation to financial bonds has been particularly helpful in generating strong absolute and relative performance. Duration, while a positive contributor to performance, has been flat compared to the wider market as we remain close to neutrality in interest rates risk.

Figure 5: Performance: YTD, YTQ (%) and calendar-year performance (pa%)

	2023 YTD	**YTQ**	**2022**	**2021**	**2020**	**2019**
Fund (EUR)	3.8	-12.3	-12.3	1.2	1.4	6.8
BM* (EUR)	2.8	-14.1	-14.1	-0.9	5.0	7.8
Fund (USD)	4.2	-10.2	-10.2	2.0	3.1	9.9
BM* (USD)	3.1	-12.0	-12.0	0.0	6.5	11.0
	2018	**2017**	**2016**	**2015**	**2014**	**2013**
Fund (EUR)	-4.0	4.3	7.0	-1.6	4.7	7.2
BM* (EUR)	n/a	n/a	n/a	n/a	n/a	n/a
Fund (USD)	-1.2	6.5	7.9	-1.2	4.9	7.3
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 January 2023, 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:

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

Belgium:
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