M&G (Lux) Optimal Income Fund

Ready to ride the turning tide for bonds

Richard Woolnough, fund manager

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Years of ultra-low interest rates made it challenging for investors to be constructive on bonds, especially government bonds. We now believe the tide is turning in favour of bonds. The fund is now **long interest rates risk** ('duration') for the first time in 10 years. We're working with the global credit team of analysts to **identify value in corporate bonds**, but currently think that being 'neutral' corporate bonds ('credit') makes sense, as the environment for credit spreads is still uncertain

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.

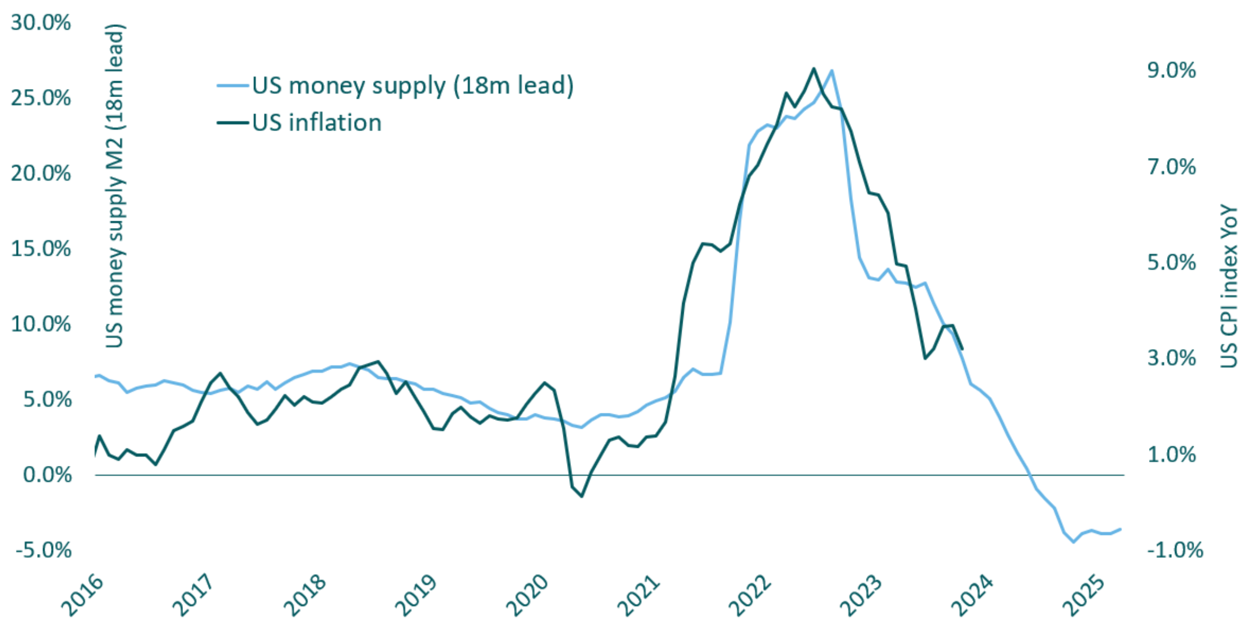
Macroeconomic view – inflation on the right path

Years of ultra-low interest rates made it challenging for investors to be constructive on bonds, especially government bonds. However, things have changed. While in the past it may have been hard to find reasons to own bonds, now we think it is starting to be difficult to find reasons *not* to own them.

The massive increase in liquidity we experienced during the COVID pandemic led to a resurgence of inflation a few months later. Central banks have now reversed course, causing money supply to fall and putting downward pressure on inflation as a result (see Figure 1). Falling money supply is typically associated with lower inflation over the subsequent 18 months. Recent money supply trends suggest that US inflation could continue its recent downward trend over the next year or so.

Falling inflation likely means central banks are at the end of their hiking cycle, effectively putting a ceiling on how far rates can go. This, together with historically elevated bond yields, has created an attractive risk-reward opportunity for duration-bearing assets, in our view.

Figure 1. Inflation is on a downward trajectory and the sharp deceleration in money supply could keep it lower



Source: M&G, Bloomberg, 31 October 2023 (latest data available; projections are for illustrative purposes only)

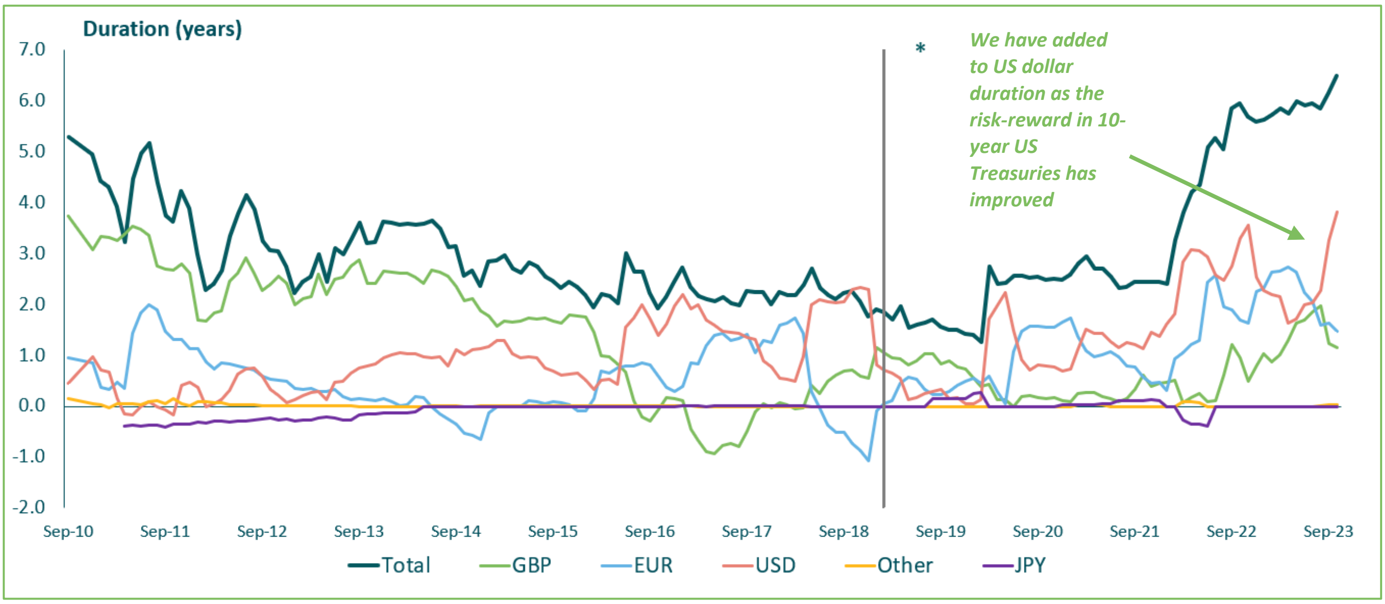
US valuations underscore long duration view

- The fund is now **long interest rates risk** for the first time in 10 years. For many years we were long credit and short duration (holding less exposure to the risk of changes in interest rates compared to others), and we knew this was against the consensus of many rivals in market.

- Fast forward to today and the fund is now long duration (see Figure 2). **We currently have rates risk at 6.5yrs vs 5.5yrs of the benchmark**. Things change and we have adapted. We are unconstrained and follow a rigorous framework which combines valuations with macroeconomic views. If we think something is expensive compared to its fundamental value, we won't buy it. If it's cheap, we tend to buy it. We always aim to take some distance from the general market noise and instead focus on what is most appropriate for our clients. This is why we believe the fund is well-equipped to navigate different cycles.

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.

Figure 2. Adding to overall duration mainly through increasing our US Treasuries exposure – We're now long rates risk



On 8 March 2019, the non-sterling assets of the M&G Optimal Income Fund, a UK-authorised OEIC, merged in the M&G (Lux) Optimal Income Fund, a Luxembourg authorised SICAV, which launched on 5 September 2018. *Data prior to the 8 March 2019 refers to the OEIC.

Source: M&G, 31 October 2023. Information is subject to change and not a guarantee of future results.

Credit neutral, but price dislocations remain

Corporate bonds, which we believed to be relatively good value for the majority of the last 12 months, are now moving back towards what we consider 'fair value'. However, pockets of opportunities still remain, particularly for active flexible funds.

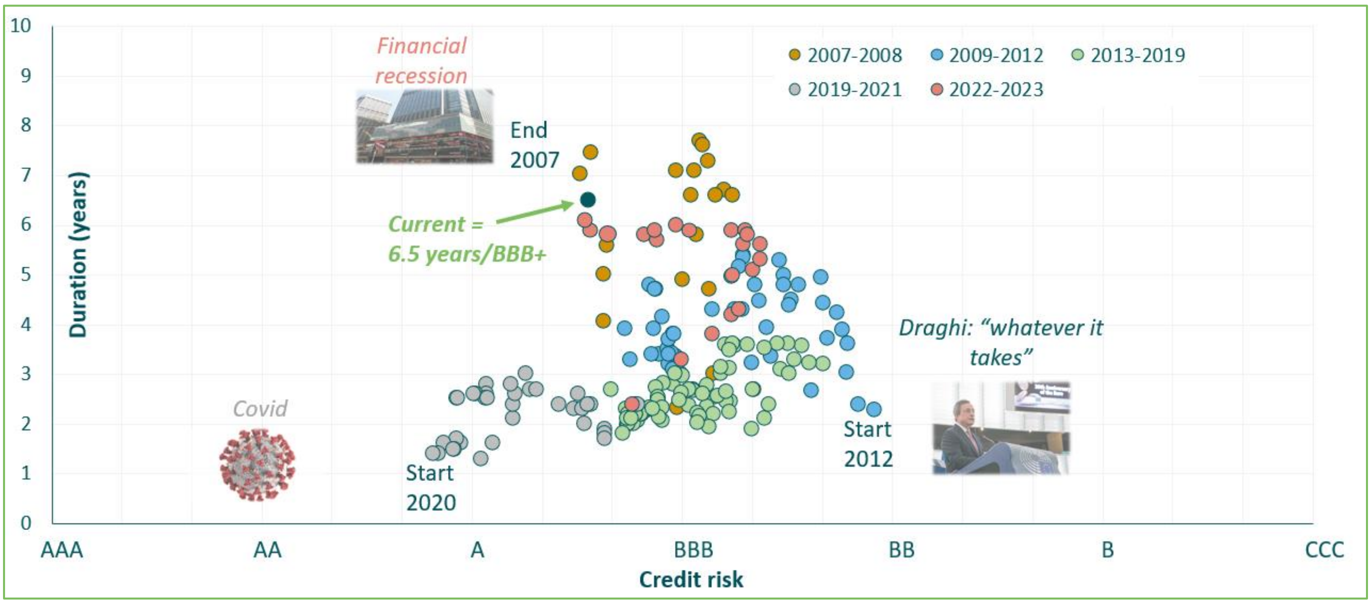
As usual, we will draw on our experienced in-house fixed income team to identify dislocations in credit markets and seek to generate alpha for our clients.

For now, we are neutral credit risk, and slightly higher in ratings quality (BBB+) versus this time last year. See Figure 3 below, which demonstrates our active approach to duration/credit since our strategy's inception.

We would argue that it's possible to have an edge in Europe and UK credit markets compared to some other funds (for instance, funds that may be focused on the US and could therefore overlook EUR/GBP issuers). We think we have a good knowledge of these markets and that can make us more reactive to capture opportunities in this space.

This year was a good example of that as the Bank of England started to actively sell its corporate bonds exposure to the market. As they are not price-sensitive (they only care about the quantity they sell!) they ended up distorting valuations, allowing us to buy bonds at what we believed to be attractive levels based on our valuation framework.

Figure 3. Duration risk versus credit risk in the Optimal Income strategy through the years



On 8 March 2019, the non-sterling assets of the M&G Optimal Income Fund, a UK-authorised OEIC which launched on 8 December 2006, merged in the M&G (Lux) Optimal Income Fund, a Luxembourg authorised SICAV, which launched on 5 September 2018. Data prior to 8 March 2019 refers to the OEIC. Note: Equity is considered with a CCC rating. Information is subject to change and is not a guarantee of future results.

Source: M&G Investments; portfolio positioning between 31 December 2006 and 31 October 2023

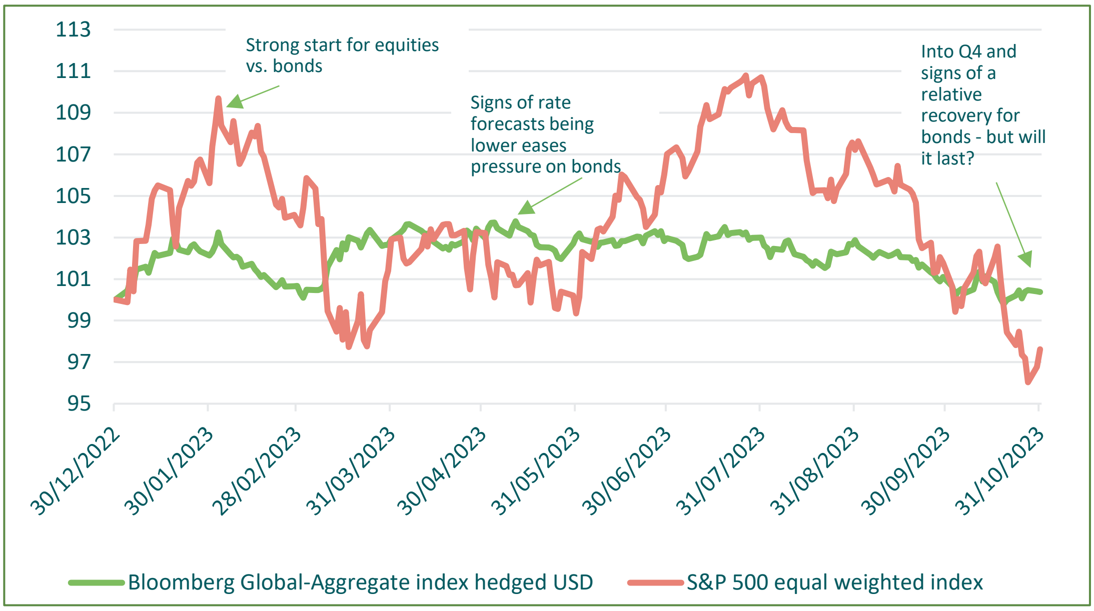
Have bonds turned a corner?

Based on proprietary research, while it is too early to conclude we're witnessing a sea change between risk assets' valuations, we do now believe a 'valuation gap' is emerging between bonds and stocks. We argue this equates to bonds being not only attractive in *absolute terms* (as previously discussed, in the context of adding duration risk), but also in relative terms. *A valuation shift could represent a valid alternative for investors in 2024, in our view.*

Investors usually focus on the S&P 500 index of leading US companies and use it as a proxy for the entire equity market. That index has experienced solid returns, generally outperforming the bond market. However, that index is heavily skewed towards some large tech names, which held up well since COVID. Indeed, about 30% of the companies in the index operate in information technology, according to an S&P 500 index factsheet dated October 31 2023.

But what if investors didn't put so much emphasis on these big tech names like Microsoft and Alphabet? For example, what if we look at the S&P 500 equal weight index (this is an index which assigns an equal weight to all its constituents, eliminating the bias towards the large tech stocks), we see a ray of hope for bonds. In the past decade, this equal weight index has strongly outperformed most bond funds – however in recent periods we see bonds starting to make a comeback, outperforming this equal weighted index. (see Figure 4, below). In the past, equities were generally looking better value compared to bonds and as a result, have generated better results for investors. But the starting point is very different today and this leaves bonds in a much better place going forward and flexible bond funds could be starting to take the lead.

Figure 4: The year-to-date performance of leading US stocks (equally weighted) vs. a global basket of high-quality bonds



Source: M&G Investments proprietary research based on Bloomberg data sourced to October 31 2023. The S&P 500 equally weighted index is hedged in US dollars, with the total return index shown. The Bloomberg Global Aggregate index is hedged in US dollars. Information is subject to change and is not a guarantee of future results.

In terms of valuations, this is also reflected in the positioning of our portfolio. Often we refer to duration and credit positioning within our Optimal Income strategy, as these make up the majority of what drives fund return. But we can also take a view on equities and to an extent (to a maximum of 20%) we can buy them when we believe the income stream offered by stocks is greater than the one offered by bonds. This has happened in the past, but it is not the case today. As a result, the strategy currently holds no stocks in the portfolio.

In summary, the macroeconomic environment changed considerably after COVID, as did valuations. After more than 10 years of being short duration and predominantly long credit, we have now changed, underlining our active and flexible approach to bond investing. The strategy is now long duration and broadly neutral on credit.

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

	2023 YTD	YTQ	2022	2021	2020	2019
Fund (EUR)	5.7	2.3	-12.3	1.2	1.4	6.8
BM* (EUR)	3.8	0.9	-14.1	-0.9	5.0	7.8
Fund (USD)	7.9	4.2	-10.2	2.0	3.1	9.9
BM* (USD)	6.1	2.7	-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

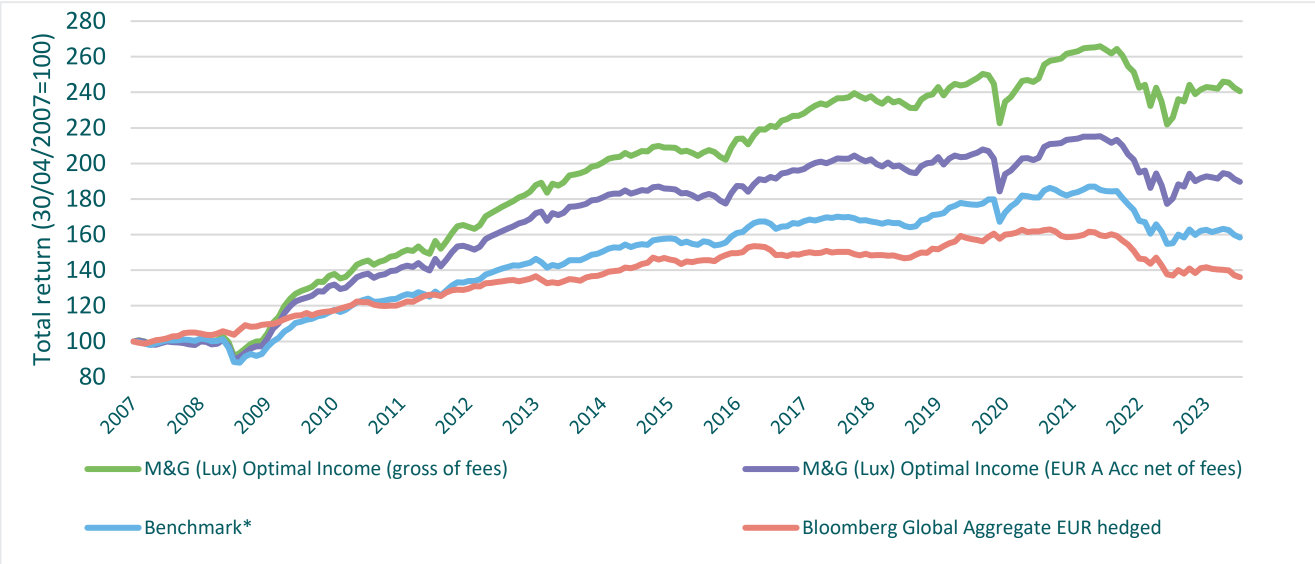
YTQ = year to most recent quarter.

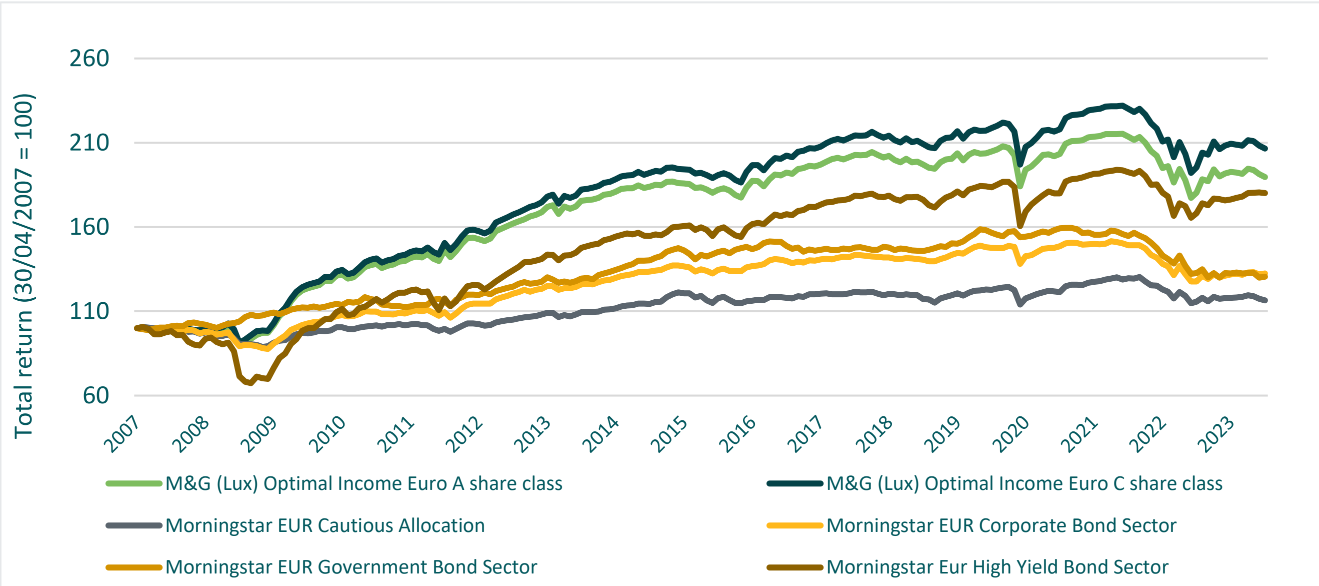
*Benchmark: 1/3 Bloomberg Global Aggregate Corporate Index EUR Hedged, 1/3 Bloomberg Global High Yield Index EUR Hedged, 1/3 Bloomberg Global Treasury Index EUR Hedged. The composite index was introduced as the fund's benchmark on 7 September 2018. Fund performance prior to 7 September 2018 is that of 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 30 November 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.

Figure 6: Fund performance since inception against benchmark and sectors





The M&G (Lux) Optimal Income Fund is a highly flexible bond fund that can invest across government, corporate and high yield bond sectors. Each sector has a different level of investment risk, including duration and credit risk, and the fund is subject to these risks given its flexible investment strategy

*1/3 Bloomberg Global Agg Corporate Index EUR Hedged; 1/3 Bloomberg Global High Yield Index EUR Hedged; and 1/3 Bloomberg Global Treasury Index EUR Hedged. The composite index was introduced as the fund's benchmark on 7 September 2018.

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Source: Morningstar, Inc., Morningstar wider universe, 31 October 2023, most recent data available for the sectors shown. Fund performance prior to 5 September 2018 is that of the Euro A-H share class of the M&G Optimal Income Fund (which launched on 20 April 2007), and which merged into this fund on 8 March 2019. Tax rates and charges may differ.

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