M&G (Lux) Optimal Income Fund

Bonds are no longer boring

The Optimal Income Investment Team

March 2024

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. Wherever performance is mentioned, past performance is not a guide to future performance.

The fixed income investable universe has grown significantly since the Optimal Income strategy was introduced in December 2006. Today, investors have a much larger pool of investment opportunities to explore. However, the benefits from having a greater opportunity set have been offset by years of near-zero interest rates, making it challenging for investors to be constructive on bonds. This has now started to change: bonds yields are elevated and as result we think there is more income potential for the patient fixed income investor. The bond market is back on its feet.

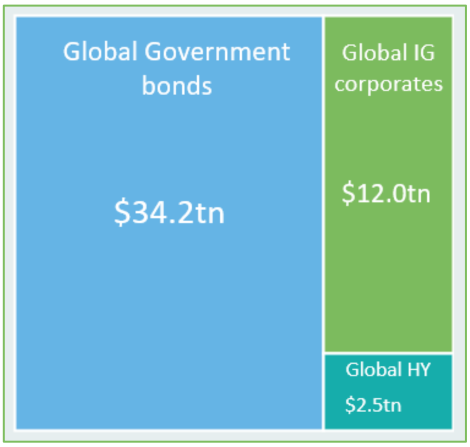
An expanding investment opportunity set

The Optimal Income strategy was introduced in 2006 and since then the investable universe for bonds has grown significantly. This, we suggest, has presented investors with a much larger pool of fixed income opportunities to explore (see Figure 1). The M&G team behind the Optimal Income strategy has also grown – more portfolio managers, investment specialists, and expert analysts support the Optimal Income franchise. We now have one of Europe's largest credit desks, too.

While expansion is one thing, it is fair to say the benefits of accessing a greater opportunity set (more bonds to invest in, typically greater liquidity, and more granular research behind issues) have been somewhat offset by years of near-zero interest rates. It has certainly been challenging for investors to be constructive on bonds in an ultra-low rates environment.

However, the market environment has changed: yields are higher – both on government and corporate bonds - and the bond market is looking perceptively more attractive. We think fixed income is no longer that boring asset class investors would consider for diversification purposes only. For us, it is an exciting and diverse asset class (with investment risks, of course) that can allow clients to grow their capital over the long term.

Figure 1 Optimal Income's global investment universe – not including company shares*



Information is subject to change and not a guarantee of future results. *Optimal Income can invest in equities, subject to a limit of 20% of fund assets; historically, allocation has been under 5% and is c0.3% today.

Source: M&G Investments, 29 February 2024.

Rates (sovereign bonds): why we favour long duration

We believe that the sharp increase in money supply during the Covid pandemic was the initial cause of inflation. As central banks have reversed course and reduced liquidity in the system, inflation has started to decline. We believe inflationary pressures will continue to ease this year, reflecting a more restrictive monetary policy. However, we expect growth to remain positive, driven in part by sustained consumer spending supported by a strong labour market and rising real wages (as inflation falls).

Nevertheless, economic growth is likely to remain subdued due to factors such as full employment, increased regulatory burdens, and higher government interventions. This contrasts with the current pricing in the bond market, where real interest rates have returned to pre-2008 levels, instead indicating an environment of higher economic growth. We continue to believe that real rates should be lower, reflecting lower potential growth. Consequently, despite the recent significant movement in nominal rates, we maintain an overweight/long duration positioning as we believe there is still potential for yields to decrease further. **Current portfolio duration is around 7.1 years at the end of February**, as shown in Figure 2 (overleaf) - the longest the fund has been 2008 and the Global Financial Crisis.

Figure 2. Duration evolution for M&G (Lux) Optimal Income Fund since 2006

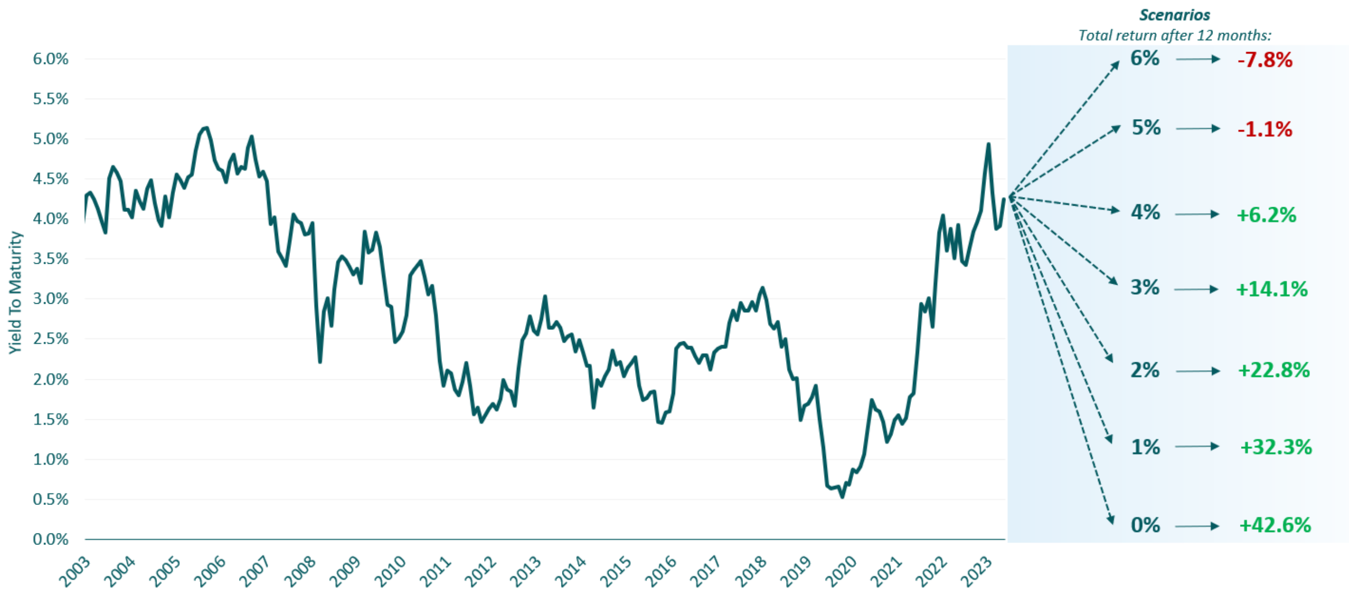
On 8 March 2019, the non-sterling assets of the M&G Optimal Income Fund, a UK-authorised OEIC, merged in the M&G (Lux) Optimal Income Fund, a Luxembourg authorised SICAV, which launched on 5 September 2018. Data prior to the 8 March 2019 refers to the OEIC.

Source: M&G, 29 February 2024. Information is subject to change and not a guarantee of future results.

Today we favour a long rates view, similar to the Optimal Income strategy during 2007-2008 and the onset of the global financial crisis. Throughout the period we have been active and often against the wider market consensus.

Our long duration view is also backed by what we see as a **favourable risk-reward trade-off** offered by bonds, particularly in the case of core government bonds (eg US Treasuries). Not long ago, rates were close to zero, leaving investors with very limited upside compared to a large downside risk. Today, it is the other way around, particularly as we now know central banks are at the end of their hiking cycle and are expected to cut interest rates in 2024-25. Figure 3 below -- which is based on M&G's own internal scenarios of expectations for total returns of 10-year US government bonds -- illustrates our belief that the risk-reward for these assets is improving.

Figure 3. Risk-reward scenarios for 10-year US Treasuries



Source: Bloomberg, 29 February 2024

Past performance is not a guide to future performance. For illustrative purposes only. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies, and/or current market conditions and are not an exact indicator.

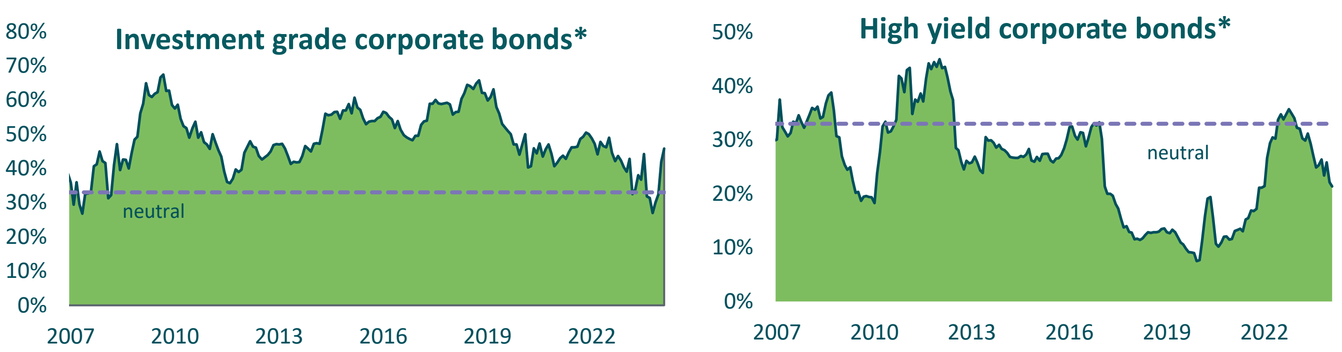
Credit: currently neutral but with some interesting opportunities in IG

Turning to corporate bonds (‘credit’), we continue to view valuations as generally ‘fair’ and consistent with an environment of positive, if subdued growth. We favour **higher quality companies** (e.g. investment grade credit at c40% of fund assets) issuing in the short-to-middle part of the credit yield curve. At the same time we have been reducing exposure to longer-dated corporate bonds due to considerable flattening of the credit yield curve. In terms of sectors, we are becoming more selective with financials and have a preference for European banks over US banks due to their lower leverage, stronger regulation, and generally limited impact from regional banks. The credit research team have been instrumental in supporting our selection.

Within **high yield**, we have been trimming since 2022-23, mainly because some of the physical bonds held have performed well and we took profits here. Currently, valuations across the asset class look a little expensive and we are happy being about 22% versus 33% neutral weighting.

In summary, we began 2024 in a significantly different position compared to the previous decade. While we had previously positioned ourselves with short duration and long credit, we now have adopted a long duration stance, while we remain relatively more cautious on credit, but within some differences across quality (**investment grade over high yield** – see Figure 4, below) and maturities (shorter-dated over longer-dated names).

Figure 4. We have been very active within **investment grade and high yield** since fund inception



* Neutral weight is 33% Internal limits are subject to change.

Source: M&G, 29 February 2024. Information is subject to change and not a guarantee of future results.

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Performance year to date

Past performance is not a guide to future performance

- The macroeconomic environment remains mainly robust, with growth showing signs of recovery while inflation remains “sticky”. Spreads have tightened further, reflecting a favourable growth environment, while rates have risen as investors reassess the timing and magnitude of future rate cuts. The main driver of relative negative return year to date has been our **overweight duration positioning** (as interest rates rose and prices fell). On the other hand, our **credit exposure has held up well**, delivering a small positive return compared to the index. Being underweight in emerging markets and some high yield issuers had a slightly negative impact, but this has been offset by our overweight exposure to investment grade corporate bonds, as well as some higher beta financial bonds and our synthetic exposure to high yield indices (credit default swaps, or CDS).

Positioning

- **The risk-reward profile from owning duration remains attractive, in our view**. The downside risk (higher rates) seems limited as central banks have already tightened significantly and are not in a position to raise rates much further. On the other hand, if inflation and growth unexpectedly disappoint, the potential upside (lower rates) could be significant.

- **Within credit, we remain close to neutral. This is not a fundamental view**. If anything, we think companies' balance sheets still look healthy while growth is stable. This is more of a valuation view. Spreads are historically tight, and as a result, we prefer to be more defensively positioned than we have been in the past.

How *might* the fund's YTM evolve over the next 12 months?

We believe an environment of elevated interest rates over the past year or so has resulted in a greater cushion for fixed income investors with long-term investment horizons. In this context, the M&G (Lux) Optimal Income Fund has also seen its cushion stay fairly elevated: The fund offered a yield to expected maturity (YTM – which is essentially an estimate of the annualised return until the expected maturity of its underlying holdings) of c4.5%, gross of fees, at the end of February 2024. While in the past, rates were near zero and there was no margin for error, this time around we have something of a buffer and that, we believe, can help us partially offset future volatility.

In our opinion, the yield to maturity, while not perfect, may provide a useful starting point to think about future returns. Considering the hypothetical table below (see Figure 5), in a hard landing scenario (not our base case), we believe the Optimal Income strategy could still generate positive returns. This is thanks to a combination of higher starting bond yields and our long duration positioning.

But what could be the worst environment for the Optimal Income strategy? A high inflation scenario, where central banks are forced to increase rates further and at the same time credit spreads will widen. Looking at the macroeconomic picture today, this is not our base case scenario. Instead, we believe we are closer to what market participants generally define as a "soft landing" -- an environment where inflation goes back to target, without necessarily causing a recession.

Figure 5. Estimated yield to maturity under various rate/spread scenarios based on current positioning

The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies, and/or current market conditions and are not an exact indicator. What you will get will vary depending on how the market performs and how long you keep the investment/product

Change in credit spreads

Change in government bond yields	-2.0%	-1.5%	-1.0%	-0.5%	No change	+0.5%	+1.0%	+1.5%	2.0%
-2.0%	26.7%	24.7%	22.7%	20.6%	18.6%	16.6%	14.5%	12.5%	10.5%
-1.5%	23.6%	21.6%	19.6%	17.5%	15.5%	13.5%	11.5%	9.4%	7.4%
-1.0%	20.5%	18.5%	16.5%	14.5%	12.4%	10.4%	8.4%	6.3%	4.3%
-0.5%	19.0%	15.4%	13.4%	11.4%	9.3%	7.3%	5.3%	3.2%	1.2%
No change	14.4%	12.3%	10.3%	8.3%	6.2%	4.2%	2.2%	0.2%	-1.9%
+0.5%	11.3%	9.2%	7.2%	5.2%	3.2%	1.1%	-0.9%	-2.9%	-5.0%
+1.0%	8.2%	6.2%	4.1%	2.1%	0.1%	-2.0%	-4.0%	-6.0%	-8.1%
+1.5%	5.1%	3.1%	1.0%	-1.0%	-3.0%	-5.1%	-7.1%	-9.1%	-11.2%
+2.0%	2.0%	0.0%	-2.1%	-4.1%	-6.1%	-8.2%	-10.2%	-12.2%	-14.2%

Soft Landing scenario   Hard Landing scenario

For illustration purposes only. This is not intended to provide expectations of the strategy's future returns or yield and spread levels. Portfolio analysis based on a one-year time horizon, assuming a static portfolio and parallel shifts in yield curves assumed to occur on day 0. This means the total adjusted carry (rates change + spread change) is added to the initial Yield to Maturity for a full year; excludes any exposure to equities. Analysis also assumes that any moves in rates and/or spreads are one-off shocks.
Source: M&G, based on Strategy and index positioning, 29 February 2024.

Figure 6: Performance: YTD, YTQ (%) and calendar-year performance (pa%)

Past performance is not a guide to future performance

	2024 YTD	YTQ	2023	2022	2021	2020
Fund (EUR)	-2.0	10.2	10.2	-12.3	1.2	1.4
BM* (EUR)	-0.6	7.3	7.3	-14.1	-0.9	5.0
Fund (USD)	-1.7	12.7	12.7	-10.2	2.0	3.1
BM* (USD)	-0.3	9.8	9.8	-12.0	0.0	6.5
	2019	2018	2017	2016	2015	2014
Fund (EUR)	6.8	-4.0	4.3	7.0	-1.6	4.7
BM* (EUR)	7.8	n/a	n/a	n/a	n/a	n/a
Fund (USD)	9.9	-1.2	6.5	7.9	-1.2	4.9
BM* (USD)	11.0	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 29 February 2024, 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.

Fund description

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, while applying environmental, social and governance (ESG) criteria. It seeks to make these investments using an exclusionary approach, as described in the prospectus. 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, including emerging markets, 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. The manager may also hold up to 20% of the portfolio in company shares when he believes they offer better value than bonds. The fund's recommended holding period is five years. In normal market conditions, the fund's expected average leverage – how much it can increase its investment position by borrowing money or using derivatives – is 200% of its net asset value.

Main risks associated with the fund

- 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.
- 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.
- 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.

- Investing in this fund means acquiring units or shares in a fund, and not in a given underlying asset such as building or shares of a company, as these are only the underlying assets owned by the fund.

Further risk factors that apply to the fund can be found in the fund's Prospectus.

The views expressed in this document should not be taken as a recommendation, advice or forecast.

This is a marketing communication. Please refer to the Prospectus and the KID before making any final investment decision.

Other important information:

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