M&G Optimal Income Fund

Taking risk where we are paid to do so

Fund manager – Richard Woolnough

FOR INVESTMENT PROFESSIONALS ONLY

November 2018

- *Volatility has proven to be the predominant theme in financial markets so far in 2018, but we remain positive on prospects for the global economy.*
- *As a result, we believe corporate bond spreads can tighten further, potentially back towards levels last seen in 2004.*
- *From a valuations perspective, we continue to prefer investment grade corporate bonds over high yield credit. This is why the fund's average credit quality stands close to its highest level since launch.*

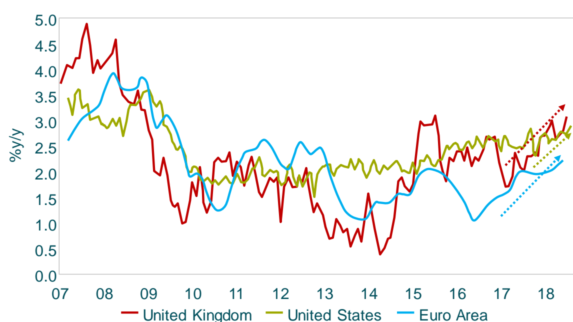
Please note that the value of investments and the income from them will rise and fall. This will cause the fund price, as well as any income paid by the fund, to fall as well as rise. In addition, the value of the fund may fall if the issuer of a fixed income security held is unable to pay income payments or repay its debt (known as a default). Fixed income securities that pay a higher level of income usually have a lower credit rating because of the increased risk of default. The higher the rating the less likely it is that the issuer will default, but ratings are subject to change.

Macroeconomic outlook: the world has normalised

In our view, monetary policy pursued by the core central banks over the past decade has worked and the world has normalised. Unemployment levels in many developed economies have fallen significantly and inflation stands above 2%. The only piece of the jigsaw not to have yet returned to 'normal' are interest rates, although rates in the US are not too far off.

We have long argued that monetary policy works with a lag. We can see this in the labour market, where for example, nominal wages were high in 2007-08 off the back of a strong global economy in 2005-06.

Figure 1. Wages and salaries are finally rising



Source: ONS, BLS, MHLW, Eurostat, Haver Analytics, DB Global Research

In the same way, despite sustained economic improvement in recent years, it has taken time for wages to rise (see Figure 1). However, there are clear signs that the US labour market is now overheating, which will drive pay higher. Both the US and UK are services-dominated economies and as a result, when wages rise, so does inflation.

While the UK is at a different stage in the cycle to the US from a monetary policy perspective due to Brexit, the two are in a similar place from an economic standpoint. We view the exchange rate as the mechanism through which the UK's economy will adjust to Brexit. For example, in the event of no-deal or a 'hard' Brexit, sterling may fall significantly against the major currencies. It remains to be seen whether Bank of England governor Mark Carney would feel comfortable cutting interest rates aggressively this time. Any disruption would throw up large mispricing opportunities as markets overreact to newsflow – something that is true of any big shock to markets.

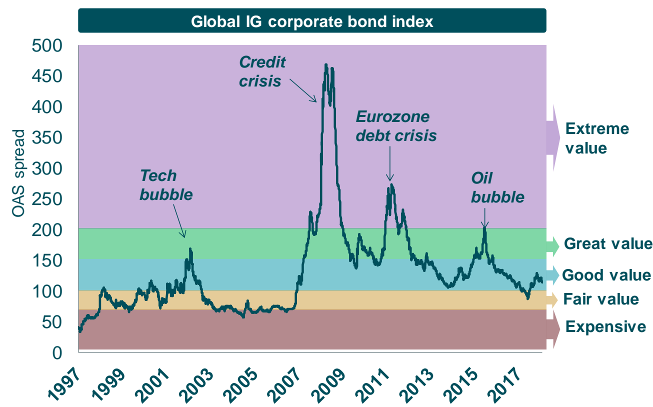
Our main concern at present is less about an imminent US recession. Rather, we worry that if the financial system is truly different since the great financial crisis – as many have argued – when central banks do eventually need to put on the brakes, they may need to put them on harder than before. At the same time, we remain vigilant about any further escalation in global trade tensions.

Positioning: being paid to take risk

Our role as investors is to take risk when we are adequately compensated to do so. In our view, corporate bond spreads currently look fairly attractive as we do not believe a recession is imminent. In this respect, with more than 30 years' investment experience, we have a more nuanced view than those who only consider current spread levels against the backdrop of the last 10 years. In our opinion, there is no reason why spreads cannot reach their tights of 2004 (Figure 2). Investors should, however, remember that past performance is not a guide to future performance.

From a portfolio positioning perspective, we generally prefer to take credit risk via long-dated investment grade bonds, as

Figure 2. Corporate bond spreads versus history

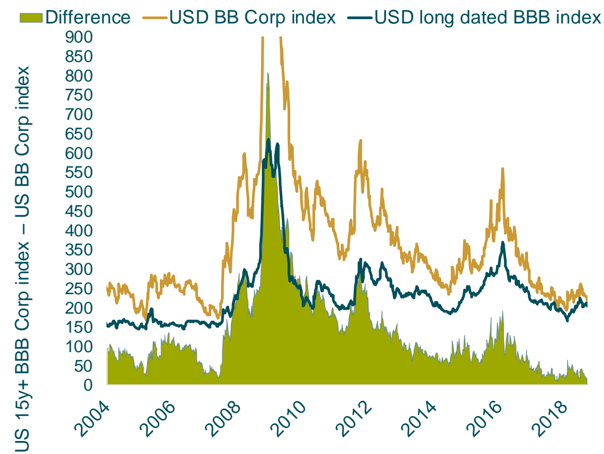


Source: M&G, Bloomberg, BofA Merrill Lynch indices, 30 September 2018

Past performance is not a guide to future performance.

credit curves appear steep and these bonds are looking more attractive than high yield bonds from a risk/reward point of view. For example, as Figure 3 shows, long-dated US dollar BBB rated corporate bonds are currently paying virtually the same as US dollar BB rated ones.

Figure 3. Long dated investment grade is attractive on risk/reward basis



Source: Bloomberg, Bank of America Merrill Lynch Indices, 14 September 2018

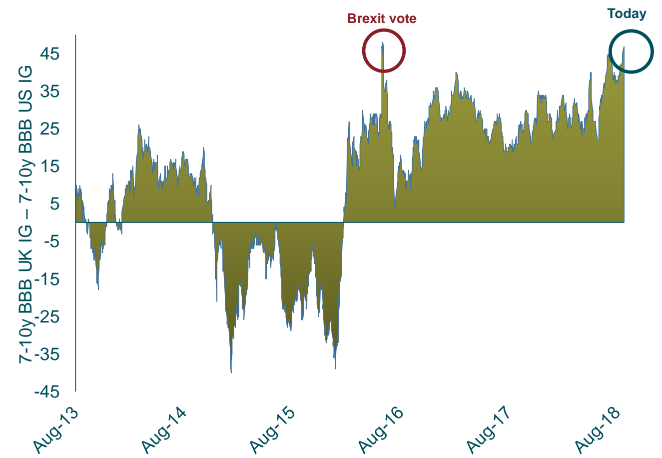
Past performance is not a guide to future performance.

We continue to see opportunities in the telecoms sector, having taken advantage of the large supply that has come from the sector in recent years. This supply, which has often been long-dated and priced with a decent new issue premium, has been largely driven by significant M&A. There have been signs lately that this supply is finally drying up (Verizon, for example, has been buying back some of its outstanding debt), and this is something that we may also be able to benefit from, as less supply could drive up prices.

We remain positive on prospects for financials, which are benefiting both from the positive economic conditions resulting in a low level of corporate defaults, and from the rising interest rate environment which helps banks' margins.

Following sustained outperformance by US dollar credit in recent months, the spread between US dollar and sterling-denominated credit has widened to levels last seen immediately following the UK's surprise Brexit referendum vote in 2016 (see Figure 4). In response, we have undertaken a number of relative-value trades, switching some US dollar credit into sterling issues from names including Goldman Sachs, HSBC and Verizon.

Figure 4. We recently switched some US into UK credit



Source: Bloomberg, Bank of America Merrill Lynch Indices, 19 September 2018

As a result of our strong preference for investment grade credit, the fund's average credit quality is close to its highest level since launch.

While government bond yields are getting back towards fair value in the US, yields in other core markets are still not particularly compelling. Therefore, we remain short duration. The bulk of the duration we do have comes from US dollar assets, while we maintain our negative duration from euro assets. We want to be out of an area that we think is approaching a bear market (European government bonds) and involved in one that is exiting from one (US Treasuries).

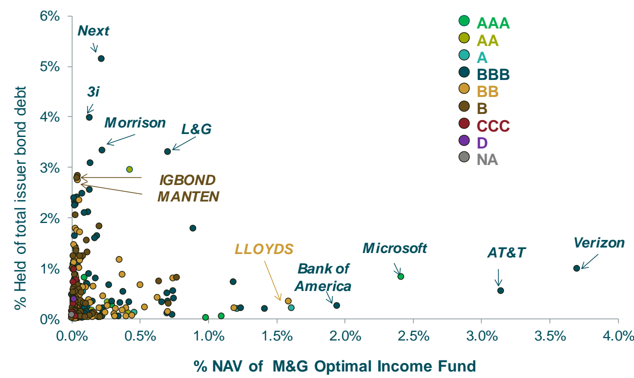
Careful consideration of market liquidity

Liquidity inevitably remains an important topic for all bond market participants. As investors, we care about liquidity and we are particularly thoughtful about how we manage a big bond fund in conditions that may change rapidly.

There are many ways in which we do this, two of which are illustrated in the charts below. Firstly, from the perspective of concentration risk (Figure 5), we think carefully not only about our overall exposure to each issuer we hold, but also what proportion of the fund's NAV this represents. So, for example, our exposure to Verizon represents around 3.7% of the fund's NAV but equates to just 1% of the company's total debt. At the other end of the scale, we hold a little over 5% of Next's total debt outstanding, yet this equates to just 0.2% of the fund's total AUM.

Figure 5. Careful consideration of concentration risk

Corporate bond holdings* as a % of issuer debt

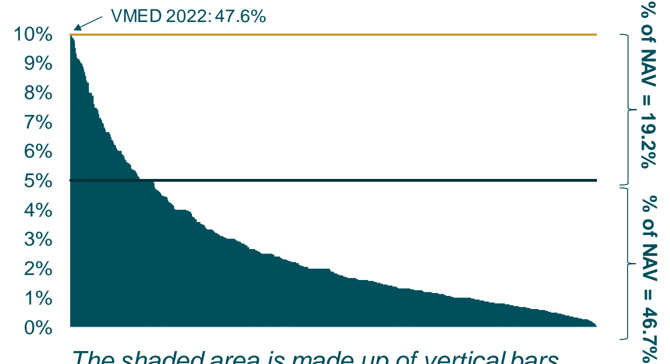


Source: M&G internal systems, Bloomberg, 31 December 2017.
**excludes derivatives and some securitised instruments*

Similarly, we have an internal restriction limiting us to holding no more than 10% of a single bond issue (see Figure 6 for the fund's exposure to single issues.) Virgin Media's 2022 issue – VMED 2022 – became an exception to this rule after we decided to reject a tender offer the company made to investors to buy back that bond, as we wanted to maintain exposure to that issue. Other investors accepted the company's offer and as a consequence we now own more than 47% of the bond. We are comfortable having a large exposure to that single issue, as it represents less than 1% of the company's overall debt.

Figure 6. Exposure to single issues usually kept below 10%

Exposure by % of issue outstanding



The shaded area is made up of vertical bars representing single corporate bond issues held in the fund. The chart shows that in the majority of cases, the fund holds less than 5% of a single issue.

Source: M&G, 25 July 2018. Excludes derivatives and some securitised instruments

These are just some of the ways in which we carefully monitor liquidity and concentration risk. Liquidity management is an integral part of the investment process at M&G and we remain acutely aware of the challenges of managing large fixed income portfolios.

M&G
November 2018

For Investment Professionals, Institutional Investors and Professional Investors only. Not for onward distribution. No other persons should rely on any information contained within. Distribution of this document in or from Switzerland is not permissible with the exception of the distribution to Qualified Investors according to the Swiss Collective Investment Schemes Act, the Swiss Collective Investment Schemes Ordinance and the respective Circular issued by the Swiss supervisory authority ("Qualified Investors"). Supplied for the use by the initial recipient (provided it is a Qualified Investor) only. In Spain the M&G Investment Funds are registered for public distribution under Art. 15 of Act 35/2003 on Collective Investment Schemes as follows: M&G Investment Funds (1) reg. no 390, M&G Investment Funds (2) reg. no 601, M&G Investment Funds (3) reg. no 391, M&G Investment Funds (5) reg. no 972, M&G Investment Funds (7) reg. no 541, M&G Investment Funds (9) reg. no 930, M&G Investment Funds (12) reg. no 1415, M&G Investment Funds (14) reg. no 1243, M&G Global Dividend Fund reg. no 713, M&G Global Macro Bond Fund reg. no 1056 and M&G Optimal Income Fund reg. no 522, M&G (Lux) Investment Funds 1 reg. no 1551. The collective investment schemes referred to in this document (the "Schemes") are open-ended investment companies with variable capital, incorporated in England and Wales in respect of M&G Investment Funds and in Luxembourg in respect of M&G (Lux) Investment Funds. In the Netherlands, all funds referred to are UCITS and registered with the Dutch regulator, the AFM. For Hong Kong only: The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer of any funds mentioned in it. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice. Shares, units or other interests in the funds mentioned in this document may only be offered or sold in Hong Kong to persons who are "professional investors" as defined in the Securities and Futures Ordinance ("Ordinance") and any rules made under the Ordinance – or in circumstances which are permitted under the Companies (Winding Up and Miscellaneous Provisions) Ordinance. In addition, distribution of this document in Hong Kong is restricted. It may not be issued or possessed for the purposes of issue, whether in Hong Kong or elsewhere, and shares, units or other interests in the funds mentioned may not be disposed of to any person unless such person is a "professional investor" as defined in the Ordinance and any rules made under the Ordinance or as otherwise may be permitted under Hong Kong law. For Singapore only: The Funds referred to in this document are each a restricted scheme under the Sixth Schedule to the Securities and Futures (Offers of Investments) (Collective Investment Schemes) Regulations of Singapore and are not authorised by the Monetary Authority of Singapore (MAS) and are not registered for retail public distribution in Singapore. M&G Investments (Hong Kong) Limited and M&G Securities Limited and the Funds referred to in this document may not be authorised, recognised or regulated by the local regulator in your jurisdiction. This information is not an offer or solicitation of an offer for the purchase or sale of investment shares in one of the Funds referred to herein. Purchases of a Fund should be based on the current Prospectus. The Instrument of Incorporation Prospectus, Key Investor Information Document, the, annual or interim Investment Report and Financial Statements, are available free of charge, in paper form, from the ACD: M&G Securities Limited, Laurence Pountney Hill, London, EC4R 0HH, GB; or one of the following: M&G International Investments S.A., German branch, mainBuilding, Taunusanlage 19, 60325 Frankfurt am Main, the Austrian paying agent Société Générale Vienna Branch, Zweigniederlassung Wien Prinz Eugen-Strasse, 8-10/5/Top 11 A-1040 Wien, Austria; the Luxembourg paying agent: Société Générale Bank & Trust SA, Centre operational 28-32, place de la Gare L-1616 Luxembourg; the Danish paying agent: Nordea Bank Danmark A/S Issuer Services, Securities Services, Hermes Hus, Helgeshøj Allé 33, Postbox 850, DK-0900, Copenhagen C, Denmark; Allfunds Bank, Calle Estafeta, No 6 Complejo Plaza de la Fuente, La Moraleja, 28109, Alcobendas, Madrid, Spain; M&G International Investments S.A. or its French branch; from the French centralising agent of the Fund: RBC Investors Services Bank France; or from the Swedish paying agent: Nordea Bank AB (publ), Smålandsgatan 17, 105 71 Stockholm, Sweden. For Switzerland, please refer to M&G International Investments Switzerland AG, Talstrasse 66, 8001 Zurich. For Italy, they can also be obtained on the website: www.mandgitalia.it. For Ireland, they are available in English language and can also be obtained from the Irish facilities agent, Société Générale SA, Dublin Branch, 3rd Floor IFSC House – The IFSC Dublin 1, Ireland. For Germany and Austria, copies of the Instrument of incorporation, annual or interim Investment Report, Financial Statements and Prospectus are available in English and the Prospectus and Key Investor Information Document/s are available in German. **Before subscribing investors should read the Prospectus**, which includes investment risks relating to these funds. The information contained herein is not a substitute for independent advice. In Hong Kong, this financial promotion is issued by M&G Investments (Hong Kong) Limited, Office: 16/F, Man Yee Building, 68 Des Voeux Road, Central Hong Kong; and, elsewhere, by M&G Securities Limited registered in England, No. 90776, authorised and regulated by the Financial Conduct Authority in the UK. Registered office: Laurence Pountney Hill, London EC4R 0HH. The Portuguese Securities Market Commission (Comissão do Mercado de Valores Mobiliários, the "CMVM") has received a passporting notification under Directive 2009/65/EC of the European Parliament and of the Council and the Commission Regulation (EU) 584/2010 enabling the fund to be distributed to the public in Portugal.
322704_343304_OEIC_EUR_ASIA

M&G INVESTMENTS