For Investment Professionals only

M&G Fixed Interest

The value of flexible tactics in global bonds

M&G INVESTMENTS

Against key themes such as rising interest rates and inflation, a flexible approach to global bond investing allows fund managers to look for the most attractive fixed income opportunities around the world.

The M&G Optimal Income Fund and M&G Global Macro Bond Fund are globally diversified bond funds with a 'go-anywhere' approach to fixed income investing. Through this flexibility, the funds' managers can constantly reassess relative value, ranging from safe-haven government bonds to corporate credit and emerging market bonds. In turn, allocating the assets of the portfolios towards those areas offering the best relative value drives the funds' long-term performance, while areas of the global bond markets where the outlook is less favourable may be avoided.

The investment process of the funds begins with an assessment by their managers of key global factors such as economic growth, inflation and interest rates. This is followed by analysis of how these considerations may affect the outlook for the main segments of the bond markets. For example, different asset classes within the fixed income universe have very different sensitivity levels to interest rate changes. Managers of flexible bond funds can therefore increase or reduce a fund's exposures in various geographic regions depending on the outlook for interest rate movements across global markets.

In doing so, a portfolio's duration may be actively managed with a freedom that contrasts with funds invested in a single country or asset class of the bond markets, such as a US government bond fund or a European corporate bond fund.

Given the breadth of international fixed income markets, M&G believes that it is vital to have a strong team behind its funds' investment processes and decisions. M&G's bond managers are therefore supported by a large fixed income research team with analysts covering all sectors of the government, financial, corporate, and emerging bond markets globally.

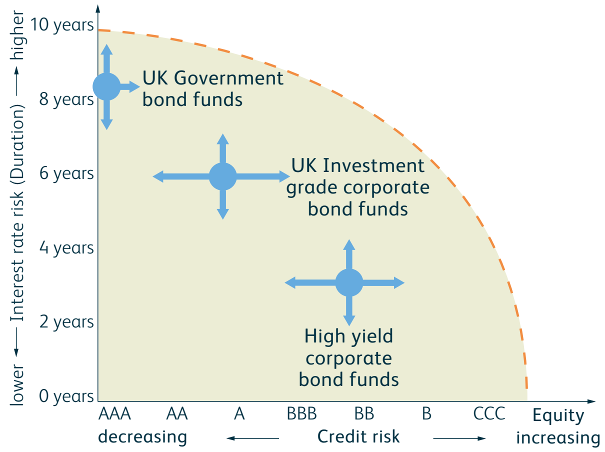
Pulling performance levers

With valuable input from this team, the allocation of assets to the managers' preferred areas of the market forms another key part of the investment approach of M&G's flexible bond funds. For example, a fund's allocation to certain types of corporate bonds may be increased as a play on a strengthening economy and a positive outlook for corporate profitability. If the economic outlook weakens and the manager's view of corporate bonds turns more negative or the risk/reward characteristics on government bonds become more positive, corporate bond exposures would be reduced in favour of higher rated government bonds. Through such assessments, the funds' asset allocations, as well as their duration levels, are actively managed to give them the potential to perform in a variety of market conditions.

Figure 1 shows how the M&G Global Macro Bond Fund can vary its positioning across duration and credit risk spectrums over time.

Figure 1: A highly flexible global bond fund

Fund can move across credit and duration spectrums



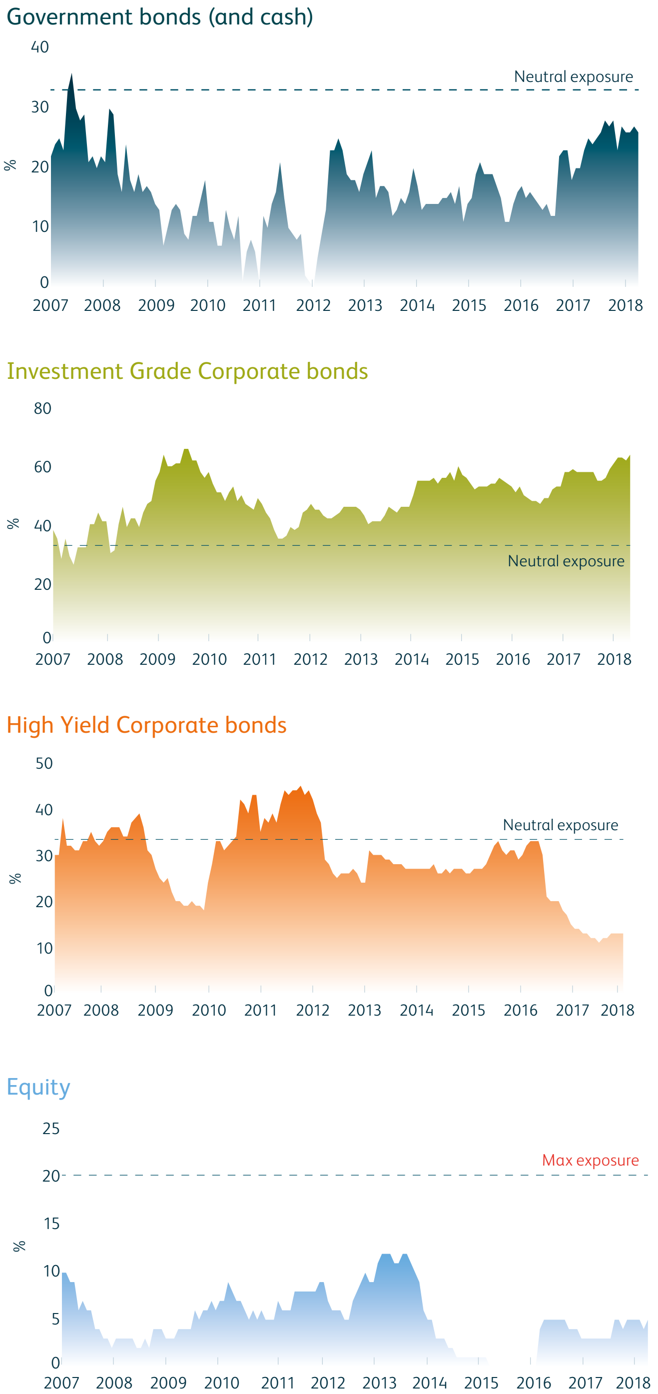
Source: M&G, October 2018.

For the M&G Global Macro Bond Fund, in addition to being able to invest in any fixed income security around the world, the manager can also invest in any currency. M&G considers currency investing to be a natural extension of global bond investing and offers further diversification benefits. As part of his investment approach, Fund Manager Jim Leaviss examines the relative attractiveness of different currencies, analysing indicators such as capital flows, economic growth and current account balances, monetary policy, and inflation. Similarly to bonds, therefore, he weighs up the relative values of currencies and assesses how they may change. The outcome of this process, as with other assets in the portfolio, is that he will only hold currencies that he expects to perform well.

Please note that changes in currency exchange rates will affect the value of your investment.

The M&G Optimal Income Fund is similarly flexible in its investment scope, allowing Fund Manager Richard Woolnough to look across the entire fixed interest universe for the best opportunities. The mandate also gives Richard full rein to express his macroeconomic views via the fund's duration positioning. In contrast to the M&G Global Macro Bond Fund, Richard seldom takes currency risk but he can invest up to 20% in equities. Richard is keen to stress that the fund is first and foremost a bond fund, but he will consider buying a company's equity issue if he considers it better value than the company's bond issuance. He therefore considers each stock on a case-by-case basis, relative to the issuing company's outstanding debt. The fund's asset allocation over time is shown in Figure 2.

Figure 2: Asset allocation over time



Source: M&G, 31 August 2018. Please note, portfolio data is based on internal sources, is unaudited and may differ from information as shown in the Monthly Fund Review.

Elsewhere within M&G's range of bond funds, the M&G Emerging Markets Bond Fund also has a flexible investment approach that enables Fund Manager Claudia Calich to invest in bonds from across the world's emerging markets (EMs). Importantly, she may allocate the fund's assets in an unrestricted way between the three main emerging market bond sub-asset classes. These are:

- Local currency-denominated EM government debt
- Hard currency (external) EM government debt, which is primarily US dollar-denominated
- Hard currency (external) EM corporate debt, also primarily US dollar-denominated

The fund's investment approach begins with Claudia's top-down assessment on macroeconomic factors such as global risk appetite and structural global growth catalysts. This is followed by analysis on a regional and country-specific level of monetary and fiscal policies, capital flows, and political and regulatory environments.

Best ideas

Based on this, Claudia decides the fund's country and currency allocations as well as its duration. The fund is not constrained by a benchmark, being diversified globally across different EMs and having no restrictions on the currencies to which it may be exposed. This flexibility allows Claudia to construct a 'best-ideas' portfolio with the freedom to invest in any EM debt security as well as in any EM currency.

In allocating the portfolio between the three sub-asset classes of the emerging market bond universe, she blends high-conviction macro calls with fundamental credit analysis. In doing so, Claudia actively manages three levers that drive the fund's performance, namely credit risk, duration sensitivity, and currency positioning.

In her view, determining the right asset allocation between government and corporate issues denominated in local and hard currencies, together with careful country and security selection, are key factors in seeking to maximise returns.

Advantageously, the fund has a much bigger opportunity set with EM corporate debt potentially enhancing its risk/return profile compared with portfolios restricted to the much smaller number of EM government bond issuers. Indeed, the EM corporate bond sub-asset class has been a particularly fast-growing segment of the fixed income universe over the past decade, and now offers widely diversified investment choices across geographies, industry sectors, credit quality, and maturities. This diversity is shown overleaf in Figures 3a-3d.

Figure 3a: EM external corporate debt by geography

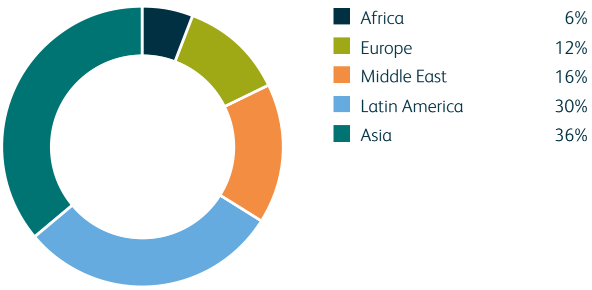


Figure 3b: EM external corporate debt by sector

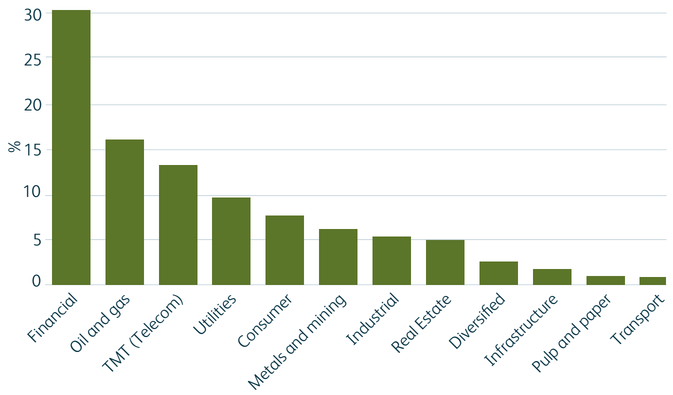


Figure 3c: EM external corporate debt by rating

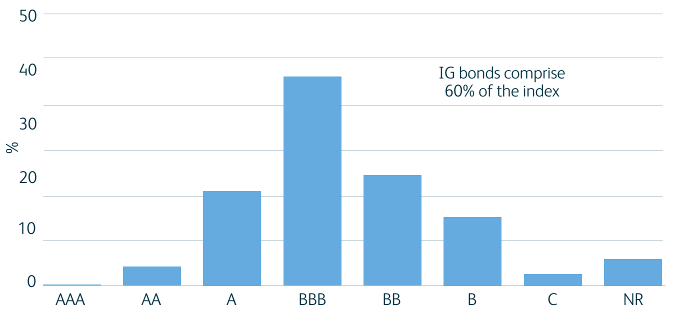
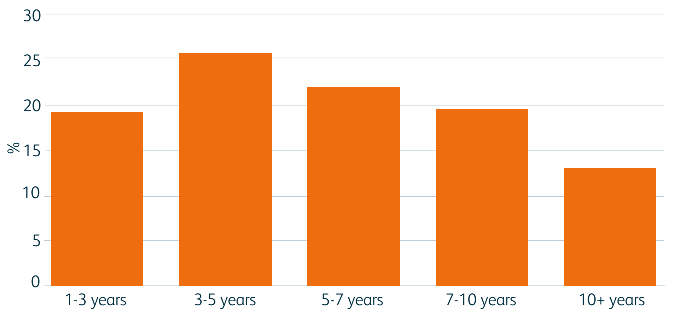


Figure 3d: EM external corporate debt by maturity



Source: Bloomberg, JPM CEMBI Broad Diversified Index, 30 April 2017.

EM corporate credit also allows for investments in countries that Claudia would invest in but where the sovereign does not issue investable debt. In addition, she may consider there are attractions of investing in bonds issued by companies that are domiciled in an EM country but have revenue streams from developed markets or from multiple regions.

Overall, Claudia's investment strategy seeks to take advantage of the fund's flexibility and allocate its assets to those areas where she sees the best relative value and avoid exposure to those emerging market bonds and currencies whose outlook she does not like. In turn, the fund's portfolio's construction process remains one that is intended to generate performance in different market conditions.

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. There is no guarantee the fund will achieve its objective, and you may not get back the amount you originally invested.

The M&G Emerging Markets Bond Fund and the M&G Global Macro Bond Fund will invest in emerging markets which are generally smaller, more sensitive to economic and political factors, and where investments are less easily bought and sold. In exceptional circumstances, the funds may encounter difficulties when selling or collecting income from these investments, which could cause the funds to incur a loss. In extreme circumstances, it could lead to the temporary suspension of dealing in shares in the funds.

The M&G Optimal Income Fund, M&G Global Macro Bond Fund and M&G Emerging Markets Bond Fund allow for the extensive use of derivatives.

The M&G Global Macro Bond Fund may invest more than 35% in securities issued by any one or more of the governments listed in the fund prospectus. Such exposure may be combined with the use of derivatives in pursuit of the fund objective. It is currently envisaged that the fund's exposure to such securities may exceed 35% in the governments of Germany, Japan, UK, USA although these may vary subject only to those listed in the prospectus.

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