

## **SHINING A LIGHT ON..... M&G OPTIMAL INCOME FUND**

### **At a glance**

For many investors moving out of cash to purely equity based investments provides too much perceived risk.

There are two ways that investors can reduce the perceived risk, firstly to take one step up on the risk ladder to bonds, or secondly to blend bonds with equities.

Bonds are an attractive asset class for several reasons, firstly they are seen as low risk, and secondly they have delivered strong returns over the past ten years.

The difficulty is that much of the assessment is based on the past and it is very difficult to predict the future. This is important for several reasons.

Firstly we assume that because bonds have been less volatile and therefore less risky this will continue, and secondly we assume that because in the past performance has been strong it will continue. However, what is becoming increasingly clear is that the bull market for bonds is coming to an end. This means that returns will be lower and potentially volatility will increase.

We are already starting to see this where one of the weakest sectors last year was gilts and this year it has reversed that trend against all expectations. An additional factor is that different asset classes will perform differently within the bond market, so for example does an investor select investment grade, high yield, gilts etc.

Investors are becoming more aware of these challenges, as are investment houses that are bringing to market a raft of different investment solutions. This makes it incredibly hard for investors to choose the direction they should go.

One fund which continues to attract new money is the M&G Optimal Income Fund with assets over £20 billion. Unlike other funds which have got bigger it continues to deliver strong returns for investors. (Please remember past performance is not an indication of future returns).

This fund may be attractive to investors looking for bond exposure but not sure where to turn. The manager can go across the spectrum to deliver the best returns and can also invest up to 20% in equities if he feels better returns can be obtained through the equity component compared to the bond.

In this update we will share some of the thoughts from the manager and also highlight some things investors need to consider.

## **Who are the team behind the fund?**

The fund was established in 2006 and has been managed by Richard Woolnough since launch. He has nearly 30 years' experience in the fixed interest market and is well respected.

He manages over £25 billion of client money for M&G, and is a significant part of the M&G story.

In a recent interview he said the responsibility of managing billions of pounds of other people's savings doesn't keep him up at night. "Obviously there is a responsibility to the investors because you have more clients, but that doesn't really change whether you're managing £100m or £1bn," he told FT Adviser. "The responsibility doesn't worry me."

He went on to describe his job as "somewhere between an intellectual challenge and a game" trying to figure out what's going to happen next in the global economy before anyone else.

## **Fund highlights?**

There are three things we will highlight in this update – the current positioning of the fund, liquidity within the market and the size of the fund.

The fund is effectively a go anywhere global bond fund. In our last update with the manager the fund was positioned fairly equally towards investment grade bonds, government bonds and high yield. Speaking to the manager at the last update he saw value in high yield and was increasing exposure in this area. Today he believes the market is overvalued and has started to reduce down this position.

He continues to have a negative view on financials reducing his exposure from 15% to almost zero. Equities had its highest weighting to equities in the last update as the manager felt equities were cheap compared to debt. At the time he used the example of Apple where the shares were cheap compared to the debt. This has now reversed and the weighting to equities is down to 2.5%.

Where the manager is finding value is in Investment Grade Bonds where his weighting has increased to nearly 50% from 30% in the last review and Government Bonds have are just below 30% from 25% in the last review.

This constant shifting of assets reflects the importance of macro positioning for the fund; looking at the global markets and deciding how best to play the market. Looking at the holdings twelve months ago and now we can see how this view can change significantly over relatively short periods. What is clear is that this fund is about Richard and his view.

The second is around liquidity and there is an argument that the bond market can become illiquid particularly during sell-offs. For example, when people are selling high yield bonds the prices go down. Richard argued that at this point they can become appealing so the fund can take advantage during periods of illiquidity and he said that there will always be periods like this. So effectively he feels that this is not something that investors should worry about and this brings us on to the third point.

The third point is very subjective. If the market becomes illiquid and there is a rush for the door then the challenge for the fund is whether holders in the fund follow the crowd. If they do and the fund is forced to sell down then potentially during the period when the markets are illiquid then the fund could suffer and the manager has never really answered this point. The assumption is that

# LWM Consultants Ltd

---

policyholders will not do this, or if they have factored this in they haven't shared it with others. This happened with property funds and investors couldn't access money for 6 to 12 months. Investors need to consider this carefully.

At the moment the fund is bucking the trend and delivering strong performance, it also appears to be able to take advantage of illiquid markets. The manager also explained that they have been increasing the team significantly to search out new opportunities.

In summary this will appeal to investors who are looking for bond fund but want to hand the decision making process to a third party. Performance has been strong and the manager is well respected. Despite what the manager says in the two updates we have had the manager has never really provided any reassurance should there be a rush for the door with the fund. The chances of this happening are perhaps slim but it has happened with property funds and it could happen. Investors just need to weigh up whether this fund is right for them or whether a smaller strategic bond fund would be a better option.

## Fund performance

Performance since launch is shown below.

	2009	2010	2011	2012	2013	2014	Since Launch
<b>M&amp;G Optimal Income Fund</b>	34.20%	9.29%	6.59%	13.75%	7.79%	4.92%	9.43% p.a.

*You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise. The total return reflects performance without sales charges or the effects of taxation, but is adjusted to reflect all on-going fund expenses and assumes reinvestment of dividends and capital gains. If adjusted for sales charges and the effects of taxation, the performance quoted would be reduced. Returns are based on the US share class.*

## Conclusion

The fund is designed for those seeking a go anywhere global bond which leaves the responsibility for choosing the type of bond to the manager. It is managed by one of the most respected managers and has delivered strong performance. Investors do need to consider whether the size of the fund could be a concern, and if there are concerns then they may wish to consider a smaller fund.

*The source of information in this note has been provided by M&G and is correct as at September 2014. These are notes from meeting the fund manager or representative and should not be seen as a recommendation to purchase any fund mentioned. Any reference to shares is not a recommendation to buy or sell. Should you wish to make a decision based on these notes we cannot take responsibility for this and you should carry out your own research before making a decision. You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well rise.*