Monthly fund review

M&G Optimal Income Fund

30 November 2009

Fund manager – Richard Woolnough

Commentary

Fund performance

The M&G Optimal Income Fund returned 0.8 % in November, ahead of the Morningstar Asset Allocation Defensive sector, which returned 0.6 % on average. The fund has nearly 70 % of its portfolio in investment grade corporate bonds, 20 % in high yield bonds, and only modest exposure to Upper Tier 2 and Tier 1 bank bonds. Over a month where riskier bonds underperformed higher rated issues as investor mood turned more cautious, this positioning was supportive of the fund's performance relative to its peer group.

Market review

Corporate bonds posted another month of positive returns with both sterling and European investment grade corporate issues gaining approximately 1 % on average. The exceptions were high yield bonds as well as Upper Tier 2 and Tier 1 bank bonds where prices fell as the credit spread widened slightly. European Tier 1 bank bonds were particularly weak, falling by 3.7 % over the month.

The decline brought to an end a sharp rally in these riskier bonds that began in April. A combination of concerns ranging from an early removal of monetary policy stimulus to fears related to restructuring of financial firms weighed on risk sentiment. The headwinds facing the financial sector were underlined by news that Royal Bank of Scotland and Lloyds Banking would received a further injection of funds from the UK government as part of major restructurings forced by EU competition rules. Risk aversion increased further when the European Commission raised concerns about Greece's public finances and banks, triggering a spike in the yield premium on Greek as well as other peripheral sovereign bonds.

Matters came to a head in the final week of November when Dubai announced that two of its flagship firms planned to delay repayment of billions of dollars of debt. Rumours quickly surfaced that European banks in particular have significant

Size of fund	€1,460.4 million
Tenure of fund manager	Since 08.12.06
Yield to maturity*	4.94 %
Number of issuers	260
Duration (years)	3.4

*Net of fund expenses.

Investment focus and approach

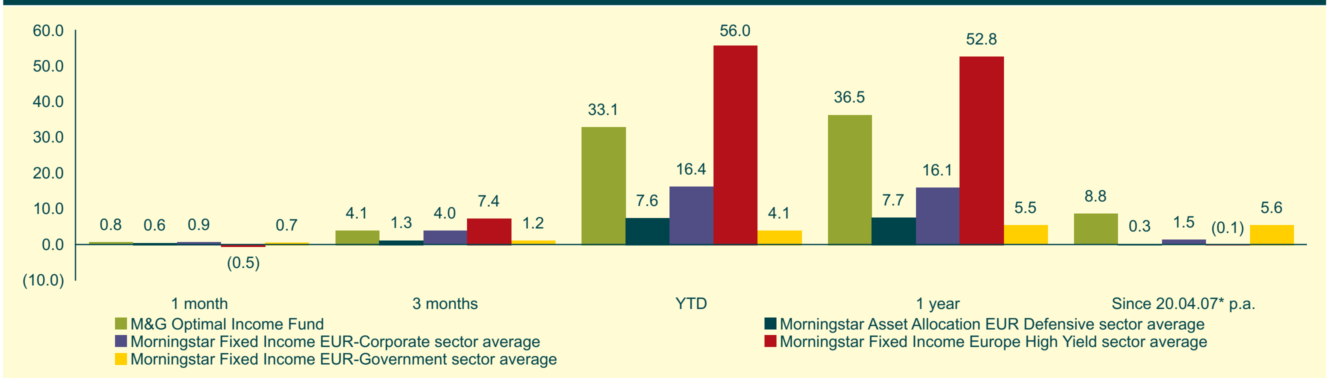
The M&G Optimal Income Fund is a flexible fund that can perform well in a wide variety of market conditions.

Central to the investment philosophy of the M&G Optimal Income Fund is that every bond has two characteristics: duration and credit risk.

Duration is a measure of how sensitive a bond's price is to changes in interest rates, and is similar to the life of a bond. Credit risk is the risk of a company defaulting on its debts.

At various stages throughout the economic cycle, credit risk or duration could be attractive, or both or neither may be attractive. The optimal income stream is the combination of duration and credit risk that maximises total return at any point in time. The manager uses a top-down investment approach to determine the optimal income stream throughout the economic cycle. To achieve the fund's investment objective, the fund manager may use derivatives.

Fund performance (total return, in euro terms, %)



* Launch of the Euro share class.

exposure to debt issued by various Dubai entities. Although United Arab Emirate's central bank later revealed that it has established an emergency liquidity facility for local and foreign banks operating in Dubai, the knock to investors' confidence in the health of the global financial system was evident. (The fund does not have any direct bond exposure to Dubai, or to the Middle East as a whole. This is largely because the severe lack of economic and financial data available in the region coupled with the large debt in Dubai has made us very nervous of lending to the region.)

Investors' jitters benefited UK and German government bonds to some extent, although volatility in government debt has persisted, a reflection of investors' uncertainty. On the one hand, there are concerns that a withdrawal of liquidity might be on the central banks' agenda. October's rise in the Consumer Prices Index to 1.5 % from September's 1.1 %, for instance, prompted talk that the Bank of England (BoE) may be nearing the end of its asset purchase programme. In the eurozone, annual inflation was estimated to be 0.6 % in November, up from -0.1 % in October. Meanwhile, European Central Bank President Jean-Claude Trichet was believed to be hinting at a removal of banks' credit support lines.

On the other hand, there are some investors that are concerned that central banks would leave monetary policy too loose for too long, creating fresh asset bubbles and the risk of runaway inflation. By the BoE's own admission, inflation is likely to rise above 3.0 % in the coming months, reflecting year-on-year effects (so called 'base effects'), driven by higher petrol price inflation and the reversal of last year's reduction in VAT. However, the UK economy is still (officially) in recession, money supply growth is feeble, and so far, unemployment is showing no signs of improving, which means that interest rates are likely to stay low for an extended period. Similarly in the eurozone, even though the region has officially exited recession in the third quarter, helped by a 0.7 % expansion in Germany, the fragility of growth means that interest rate increases are unlikely to occur in the near term.

Nonetheless, fund manager Richard Woolnough continues to expect that the increasing supply of government bonds and eventual ending of QE will result in an increase in yields. The fund has therefore maintained a short duration position - the fund's duration was 3.4 years at the end of November, compared with a neutral level of around five years.

Changes to the portfolio

During the month, fund manager Richard Woolnough took up a new and attractively priced seven-year bond from United Business Media (UBM). Having moved away from its traditional focus on newspapers, UBM is now a globally diversified media business. Proceeds from the bond issue would be used to pay down debt.

Richard also bought a BBB rated bond maturing in 2021 from property investment group Segro, which recently acquired rival Brixton. He believes that Segro should be a stronger credit for the acquisition of Brixton's high quality portfolio at a knock-down price.

In the non-investment grade bond market, Richard subscribed to several new issues, including a five-year issue from Abengoa, a Spanish engineering company. The unrated issuance offered a coupon rate of 9.6 %, to be raised to 10.95 % if the company does not get a rating within the next 12 months. New issues from European beverage company CEDC, satellite communications provider Inmarsat, Italian carmaker Fiat, and corrugated packaging manufacturer Smurfit Kappa were added to the fund as well.

The overall structure of the portfolio has remained broadly unchanged with approximately 70 % of the fund invested in investment grade corporate bonds and 20 % in high yield bonds.

Derivative positions

Derivative overlay positions and rationale
Short 10-year gilt futures **Government bond yields to rise**
Short 5-year German government futures **Government bond yields to rise**
Short 10-year German government futures **Government bond yields to rise**

Asset allocation (%)

Asset	Fund
Government bonds	2.9
Investment grade bonds	68.8
High yield bonds	20.4
Secured loans	0.4
Equities	6.0
Cash	1.4

Currency exposure (%)

Currency	Fund
Euro	94.7
Sterling	5.0
Dollar	0.3

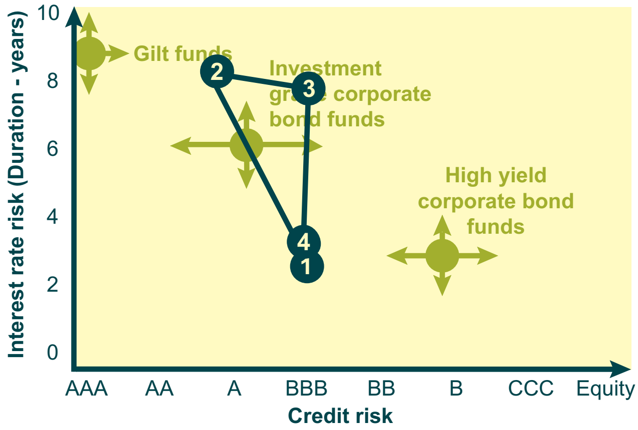
Credit rating breakdown (bond portion, %)

	Fund	CDS, bought protection
AAA	5.6	0.0
AA	4.7	0.5
A	24.6	1.4
BBB	34.5	1.3
BB	11.5	0.0
B	6.4	0.0
CCC	1.2	0.0
No rating	4.0	0.0

Top 10 issuers (%)

	Fund
HSBC	2.8
Barclays	1.9
BAA	1.9
BT	1.3
JP Morgan	1.2
Bank of America	1.2
Lloyds Banking	1.1
EDF	1.1
Banco Santander	1.1
Vodafone	1.0

Portfolio positioning



All investment assets can be characterised by the combination of duration and credit risk that they offer. For each asset class, the arrows in the chart represent the typical range of investments that fund managers can buy. For the M&G Optimal Income Fund, Richard Woolnough's preferences for duration and credit risk – and hence for the income streams offered by different assets – will depend on his outlook for interest rates and credit and will be reflected in his positioning of the portfolio.

1: Jan 2007: growth strong, central banks raising interest rates – short duration

2: June 2007: credit crunch – long duration, less credit risk

3: April 2008: investment grade spreads widest in years – increased exposure to credit

4: December 2008 to date: reduced duration on fears of oversupply of government bonds