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# M&G Cautious Multi Asset Fund

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**Q&A with David Jane,  
manager of the newly-launched M&G Cautious Multi Asset Fund**

**February 2007**

## *Asset allocation*

**You say that asset allocation is the most important investment decision, but what about stock selection?**

For multi-asset funds, we believe asset allocation is the key determinant of portfolio returns. With this in mind, our focus for the M&G Cautious Multi Asset Fund is to generate most of our outperformance by finding the best asset classes and investment themes, and backing those ideas with conviction.

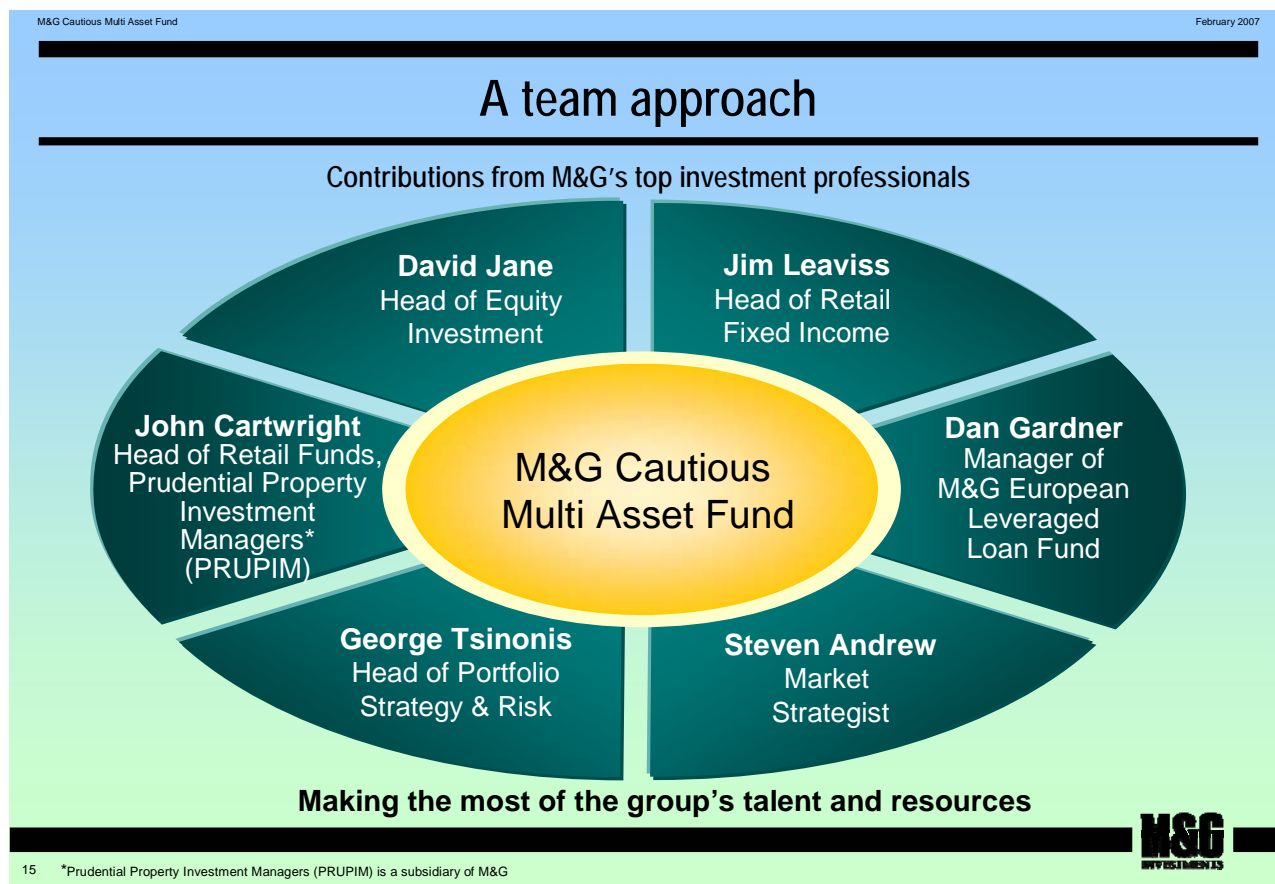
Take last year's asset class returns for example. Equities generated gains in excess of 15%, while bonds failed to deliver a positive return at all<sup>1</sup> – picking the right asset classes and avoiding the poorly performing ones would have given you an unassailable advantage. In fact, trying to make up for the gap in asset class returns by relying on stock selection in bonds would have given you a mountain to climb – generating outperformance of 15% is no easy task, no matter how good your stock-picking skills.

That's not to say that stock selection is irrelevant – we just leave that particular skill in the hands of the managers of the funds we invest in. We see stock selection as a way of enhancing our returns, rather than the primary source of performance.

**Does a bottom-up investment house like M&G have the appropriate asset allocation skills? What experience do you have in this area?**

Our teams across a broad range of asset classes – equities, fixed income, property, leveraged loans, collateralised debt obligations (CDOs) – give us access to investment expertise that's unrivalled in the City. And this expertise gives us a pretty good idea of what we can expect in terms of risk and return for each individual asset class – we get an honest, unbiased view from our colleagues who sit just a few yards away. There's a lot to be said for working with the 'home' team.

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Source: M&G, February 2007

Assessing and making decisions on risk/reward profiles for different asset classes is precisely what I have been doing for the M&G Managed Fund, which I have managed since July 2002. The key investment decision I've had to make in that period – overweight equities, underweight bonds – has been the right one. The fund has been top quartile in its peer group (the IMA Balanced Managed sector) over 1 year, 3 years and the entire period of my management, and has beaten its benchmark over each of those time periods. A significant part of that outperformance was generated by asset allocation<sup>2</sup>.

All that is different with the M&G Cautious Multi Asset Fund is that I have more investment levers to pull – it's a development upon a process we had already. I work very closely with the M&G Portfolio Strategy & Risk team, and together we aim to create a diversified portfolio with an optimal risk/reward profile to meet the fund's objective of delivering steady, competitive returns across different market conditions and hence increasing wealth for our investors in the long run.

## How does the M&G Portfolio Strategy & Risk team help in the asset allocation process?

The Portfolio Strategy & Risk team, headed by George Tsinonis, plays a crucial role for M&G Cautious Multi Asset Fund. Steven Andrew, our market strategist, provides invaluable analysis of economic data and asset class performance to identify potential investment opportunities. Natalia Ryazantseva, our head of risk, is pivotal in the portfolio construction process – she makes sure that the fund is sufficiently diversified and that it is taking the appropriate risks to deliver on its objectives. By finding investments that have low or negative correlation with the rest of the portfolio, we aim to minimise risk as well as maximise returns. I meet with the team twice a week to monitor existing positions and discuss new ideas. Regular discussion allows us to challenge our assumptions and helps us to develop conviction in our investment choices.

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## **What is your time horizon for asset allocation calls?**

Normally three to five years. About 80% of the M&G Cautious Multi Asset Fund will be invested in what I call ‘structural’ asset allocation positions, which provide diversification through exposure to different asset classes and geographic regions. This part of the portfolio will be held on a long-term basis and will usually be held in M&G funds.

## ***Fund selection***

### **What’s the advantage of investing in M&G funds?**

First of all, you get access to our scale and expertise, which has delivered strong performance across a broad range of asset classes. 13 of our funds were top quartile under the respective fund manager’s tenure, with six of these ranked top decile<sup>3</sup>. Not only that, the fee structure for the M&G Cautious Multi Asset Fund means that you get access to our funds at a very low cost.

We have a competitive annual management charge of 1.35% as well as a total expense ratio (TER) of 1.70% which compares favourably with the IMA Cautious Managed sector average of 1.91%<sup>4</sup>. The ability to access specialist areas such as leveraged loans for such a low fee is, we believe, a highly attractive proposition.

### **What if M&G funds underperform?**

Although we have full confidence that our managers will outperform in the long term, there will of course be times when our funds underperform over shorter periods.

But as I mentioned earlier, our investment philosophy is that asset allocation will be the key driver of performance for M&G Cautious Multi Asset Fund, not the relative performance of the funds we invest in. You would have been much better off last year in an underperforming equity fund than an outperforming bond fund.

### **When would you own external funds? How do you go about picking them?**

This is not a fettered fund, so I have no issue with investing in external funds so long as the potential returns outweigh the management fees I have to pay. This would include exchange traded funds (ETFs) which would give me exposure to an asset class at relatively low cost.

I would also buy funds managed by other investment houses if I wanted to access areas of the market where M&G doesn’t have the expertise. For example, if I became bullish on Taiwanese equities, I couldn’t invest in an internal fund that would give me direct exposure. In this instance, as with other external funds, I would look for an appropriate fund with guidance from Old Broad Street Research (OBSR). We already work actively with OBSR to source third-party funds where appropriate through their extensive research capabilities..

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## *Direct holdings*

**How much of the fund will be invested in direct holdings? What is your time horizon for these investments?**

About 20% of the fund will be invested in direct holdings, which I expect to be almost always in equities. These ‘tactical’ holdings, representing specific investment themes, will have the highest potential returns, and also volatility, in the portfolio – subsequently, this is the primary source of short-term performance. I will pick a basket of five to ten stocks for each theme, with an average holding period of six to 12 months.

## *Fund objectives*

**We have seen several new fund launches in the cautious managed sector. How is M&G’s fund different?**

First of all, our fund offers a much broader range of asset classes than the traditional options of equities and bonds. My problem with the traditional model is that it doesn’t provide adequate diversification.

With the recent changes in regulation, I can now invest in property as well as assets previously unavailable to retail investors, such as leveraged loans. We offer a portfolio that is truly diversified, both in terms of asset classes and geographic spread. We have a global perspective and aim to diversify our investment risk for our unit holders – we are perfectly happy to step out of line with our competitors in order to achieve this. We’re not in it to protect our business risk.

Secondly, we have the flexibility to back our convictions, within the limits of the sector (60% maximum in equities, 20% maximum in “unapproved” investments including leveraged loans and CDOs). We believe we can add significant value by investing in areas which, in our view, will perform the most strongly and avoiding those areas which will perform the most poorly.

Traditional cautious managed funds usually favour ‘tilts’ around a predetermined asset allocation of 60% equities, 40% bonds, moving their weightings by small amounts. We don’t think that this approach serves the investor’s interest. A year ago, many fund managers were predicting negative returns from bonds – but that didn’t stop some from having close to 40% of their fund in a declining asset class. We’re quite happy to hold nothing in an asset class if we don’t believe it’s going to make our unit holders money.

**Truly flexible, high conviction – doesn’t this mean it’s a high-risk portfolio?**

In our view – certainly not. We want is to create a diversified, low-risk portfolio that doesn’t compromise on returns. We aim to keep the fund’s volatility similar to the average in the IMA Cautious Managed sector, but we can do this by maintaining a flexible approach and backing our conviction.

The fund’s volatility is currently 4.74%, much in line with a peer group average of 4.36%<sup>5</sup> (see the table below) – but we have exposure to assets with favourable risk/reward profiles such as property and leveraged loans which most of our competitors simply won’t have.

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## (4) Low-risk profile

Keeping volatility similar to sector average

Fund	Volatility
Schroders S&P Cautious Managed	6.48
New Star Cautious Portfolio	5.45
Credit Suisse Multi-Manager Cautious	5.33
Jupiter Merlin Income Portfolio	5.31
F&C Multi-Manager Distribution	4.85
M&G Cautious Multi Asset	4.74
<i>IMA Cautious Managed sector</i>	4.36
Investec Cautious Managed	3.45
Gartmore Cautious Managed	3.30

Maximising returns, minimising risks

7 Source: M&G statistics using Standard & Poor's data for the 12 months ended December 2006. Volatility for M&G Cautious Multi Asset Fund calculated as a historic figure, assuming the proposed fund was held for one year.



Source: M&G, February 2007

### Why do you have an absolute return objective? Is there a benchmark for the fund?

We aim to deliver absolute returns because that's what our customers require to meet their long-term savings objectives. When we were developing this product, I had an investor in mind who wants a safe-haven for their money which delivers steady, positive returns across different market conditions. We are convinced that we can provide this through a low-risk portfolio that's diversified across a broad range of assets.

We're not aiming to beat a particular benchmark because there really isn't an appropriate one to compare ourselves against, but we will aim to deliver a competitive return relative to our peer group, the IMA Cautious Managed sector, especially on a risk-adjusted basis.

### Why don't you have a specific cash-plus return target like some of your competitors (Scottish Widows, JPMorgan)?

In my view, giving yourself an absolute return target means that you won't be maximising your returns. Human nature is such that once you hit a target, you won't do much more than that. What I'm trying to do is to deliver the highest return for an acceptable amount of risk and I believe this approach will serve the customers' interest best in the long run.

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**There was a recent article in the Financial Times (*FSA warns on diversified portfolios*, 31 January 2007) talking about the increasing correlation between asset classes. How do you ensure that your portfolio is truly diversified?**

The FSA's observation was spot on. The correlation between asset classes has increased, simply explained by the global 'carry trade', ie investors borrowing money at low rates and investing in higher return assets, moving all risk assets in the same direction. Cash has been the only true diversifier.

We are conscious of all this and plan to manage the M&G Cautious Multi Asset Fund accordingly – we don't want to be gearing up on the same theme. We like leveraged loans because of the diversification benefits provided by their cash-like returns and we own lowly-correlated assets such as infrastructure funds (utility-like cashflows growing in real terms, with very little sensitivity to economic activity and diversified across different projects in different countries). Public Finance Initiatives (PFI) may be another interesting area in this regard in the future.

What we're not going to do is gear up on the equity exposure that we already have by investing in equity hedge funds or private equity. These areas have done very well from a return perspective during a four-year equity bull market, but investing in them isn't exactly in the spirit of a cautious, diversified, low-risk portfolio, which is what I believe people are after. We're also not big fans of direct commodity exposure – a bar of gold doesn't give you an income stream and the only way you make money is by speculating on its price movement. In my view, it's not a proper investment.

It's also important to keep the correlation of asset returns in perspective. Equities, bonds and property are correlated but nowhere near to the tune of 1 – the benefits of diversification aren't lost completely.

## *Current views*

### **Do your views differ from those of the asset class specialists?**

My views on asset classes are broadly in line with those of the specialists. We talk on a regular basis to keep up with what's going on and discuss key issues.

The only major difference worth highlighting is my view on property which is much more bullish than PRUPIM's\*. I believe that property is structurally undervalued and that investors will pay higher prices for the security of their income stream.

Historically, investors have valued property (rental yields) against bonds because in the past, the biggest buyers of property were leveraged players who required a return in excess of borrowing costs. But things have moved on a bit since then and I believe new investors in the market, especially long-term institutional players, will look at the asset class differently.

Look at it this way. Which would you rather have? A building generating rental income which grows in line with GDP over the long term and where at the end of the day you own a piece of the land; or would you rather lend money to Gordon Brown in the knowledge that governments go bust from time to time? Most people that I've spoken to go for the building without any hesitation.

John Cartwright's view is that property looks fairly valued relative to historic returns and valuations. I believe there's a lot more to go for and that ultimately, property yields will be lower than bond yields – just as the equity earnings yield lost its premium to bond yields.

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## Isn't your property weighting light given your positive view on the asset class?

We're aiming to have 20% of the fund in property at the outset, which is a lot more than many of my competitors have, and my long-term plan is to increase that weighting over time. While I'm optimistic on the asset class in the long run, I can't ignore the fact that there is a cyclical element to returns.

## Why do you have such a low weighting in bonds compared to the peer group?

I have been bearish on the asset class because in my view, the shift in bond yields to historic lows, caused by slowing inflation, was unsustainable. Bond yields have since risen to more attractive levels, but I see better investment opportunities in other asset classes. I'm not going to buy bonds just because my competitors own a lot.

At launch of the M&G Cautious Multi Asset Fund, our fixed income weighting will be invested in Gilts.

We remain cautious on credit risk and continue to avoid corporate and high yield bonds. Credit spreads are already thin and we don't expect the gap to narrow any further.

## How scalable is the product? Are there going to be liquidity issues?

When we started developing the fund, we were keen to ensure that the investment process would be repeatable and scalable. M&G's equity funds and bond funds could take on a lot more money, while liquidity shouldn't be a problem for property and leveraged loans. For these asset classes, the respective teams have a monthly meeting to discuss liquidity management, looking into the fund's potential cash flows six to 12 months in advance.

**M&G**  
**February 2007**

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<sup>1</sup> FTSE All-Share Index returned 16.7% in 2006, while FTSE Gilts 5-15 years returned -0.1% (source: S&P)

<sup>2</sup> Source: S&P, Lipper data for period ended 31 December 2006

<sup>3</sup> Source: M&G, S&P, as at 31 December 2006

<sup>4</sup> TER calculated by M&G as at January 2007. Peer group data from Defaqto Aequos as at February 2007.

<sup>5</sup> Source: M&G, using S&P data for the 12 months ended December 2006. Volatility for M&G Cautious Multi Asset Fund calculated as a historic figure, assuming the proposed fund was held for one year.