M&G Optimal Income Fund

Recent market volatility: fund performance and positioning

Fund Manager – Richard Woolnough

On May 22, Federal Reserve (Fed) Chairman Ben Bernanke indicated to Congress that the bank may start tapering its quantitative easing programme at one of its "next few meetings". The prospect that liquidity may start to be withdrawn from markets before the end of the year has led to a substantial and continued sell-off across financial markets, with 10-year US Treasury yields rising by 100 basis points. Sterling-denominated investment grade bonds have lost 5.1% and euro-denominated bonds are down 2.1%, while euro-denominated high yield bonds had fallen 2.8% over this period to June 27. Equity markets too have retreated, with the S&P 500 Index down 2.6% and the FTSE 100 Index declining 9% over the same period in local currency terms.

Against this backdrop, the M&G Optimal Income Fund has lost 4% since its May 22 peak (source: Morningstar, Inc, as at 27 June 2013, sterling class A shares, net income reinvested, bid to bid basis). The majority of the fund's losses have resulted from its investment grade corporate and financials exposure, due to the relatively long duration nature of these assets. With riskier instruments such as high yield bonds and equities also affected by the sell-off, the fund's holdings in these areas have also lost ground. A price swing has further contributed around -0.6% to returns. However, the fund's short futures position has been beneficial. Despite recent negative returns, the fund is ranked top quartile year-to-date in the IMA £ Strategic Corporate Bond sector (to June 21 2013, latest available data).

Portfolio positioning

Fund Manager Richard Woolnough has long believed that the US economy is emerging strongly from recession, and in his view, the Fed should have ended quantitative easing already. As a result, he has not significantly altered the fund's positioning in response to the recent volatility, but has instead been taking advantage of the sell-off to add certain holdings that he believes offer value at present.

For instance, he has added to the fund's high yield exposure since the start of June, taking it from around 24% at the end of May to around 30% currently. Having reduced his exposure earlier in the year, Richard now believes the high yield segment offers better value and he increased his positions in both the North American HY CDX and the Markit iTraxx Crossover index. A recent new issue from British motoring association the AA provides a good example of the asset class's newfound attractiveness: having initially been marketed with an indicative coupon of 6.5%, the 2019 bond was eventually priced with a 9.5% coupon in June.

Richard has gradually increased the M&G Optimal Income Fund's exposure to equities since the start of 2013. While the performance of equities and high yield bonds has historically been closely correlated, he thinks that equities currently look cheap relative to bonds.

Richard has also added 5-year Treasuries to the fund in recent weeks. These assets have sold off considerably during the current volatility and Richard believes the Treasury yield curve should move steeper. The fund's duration therefore has risen slightly, to 3.1 years at the end of the month.

Richard continues to find value in the corporate credit space, particularly in sterling-denominated bonds, where he believes investors are being over-compensated for the risk of potential default. Assuming a 40% recovery rate, BBB sterling-denominated bonds are pricing in a default rate of 21% over five years, while the average default rate for such bonds is only 2%, according to research from Bank of America/Merrill Lynch. Within investment grade credit, Richard finds the lower rated – and hence higher yielding – area of the sterling-denominated market the most attractive.

Outlook

Richard remains confident that the US economy is on the road to recovery. The country's housing market continues to gather momentum, and with demand currently outpacing supply, he expects construction to boom. Historically, the positive effect that this has on construction sector jobs then filters through to the broader labour market. However, even if the Fed does begin to taper its supply of liquidity to the bond markets, interest rate hikes look to be some time away.

On the other hand, interest rates in the UK look likely, in Richard's view, to stay on hold for far longer. The Bank of England's focus is turning away from inflation targeting towards stimulating growth, and as a result, the bank is likely to tolerate inflation higher than its usual 2% target. Nevertheless, Richard believes the UK economy does not look as weak as the latest GDP figures suggest, particularly when employment and housing data are taken into account. UK employment is well above previous recession levels, while the housing market is showing signs of renewed life.

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Source of all portfolio data: M&G, preliminary as at 27 June 2013.