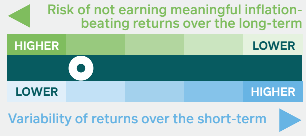
M&G Investments

M&G Enhanced Income Fund

Multi-asset

Q3 2021

Risk profile



Fund facts

Fund managers
David Knee
Roshen Harry

ASISA category
South African - Multi-Asset - Income

Benchmark
STeFI Composite Index measured over a rolling 36-month period

Inception date
1 July 2009

Fund size
R848 563 150

Market overview

The third quarter of 2021 saw a notable shift toward investor risk aversion compared to the first half of the year, as several mounting concerns around global growth took their toll on financial markets. Among the most influential were: the relentless spread of the Covid Delta variant; indications of a sooner-than-expected start to the US Fed's (and other central banks') policy tightening; and stricter Chinese regulatory policies. Global bond markets came under pressure, and many equity markets produced negative returns, with emerging markets and currencies lagging developed markets. Technology and Resources counters were among the worst performers, the latter due to the fall in commodity prices (apart from oil), especially in September.

In South Africa, the broad equity market was only marginally negative (in rand terms) over the quarter. Good gains in financial, retail and property stocks helped to largely offset losses in some Resources shares, as well as Naspers and Prosus. At the same time, SA bonds bucked the global trend with positive returns. However, the rand lost ground against the major global currencies.

In the US, the economy grew at a robust 6.7% (q/q annualised) pace in Q2 2021. Combined with an acceleration in inflation and improving employment data, the US Federal Reserve signalled that its long-standing easy monetary policy was set to be tapered. It expects to purchase fewer assets in the fourth quarter, and to start hiking interest rates gradually in 2023, somewhat sooner than expected by the market. This weighed on US Treasuries and the equity market, and prompted some analysts to scale back their growth estimates.

Both the Bank of England and the European Central Bank followed the US Fed's tighter policy forecast in September, although their monetary tightening is expected to be less aggressive. The former said that the case for modest tightening had strengthened amidst rising inflation concerns, while the latter announced it would start tapering the pace of its net asset purchases due to improved economic and financial conditions. UK GDP growth was revised higher to 5.5% (q/q annualised) for Q2 2021, while that for the Euro area came in at 2.2% (q/q annualised).

Japan's economy finally recorded positive growth, with a 0.5% (q/q annualised) GDP expansion in Q2 compared to -1.0% in Q1. The Bank of Japan left its key short-term interest rate unchanged at -0.1% at its September meeting, as expected. But unlike its counterparts, it continued to reinforce its message that the current very low levels would stay in place for as long as necessary.

In China, the economy grew at 1.3% (q/q annualised) in Q2. However, as Q3 wore on, there were increasing indications that this growth was losing steam, compounded by further concerns over the negative impact on growth of the government's regulatory crackdown.

The spot price of Brent crude oil gained 4.5% in Q3, and has risen nearly 52% for the year to date. The sharp increase has been fuelling global inflation, with the price at around US$80 per barrel at quarter-end. Other commodity prices were mostly weaker over the quarter - the main exception was aluminium, which gained 13.0%. Otherwise, gold was down 2.0%, platinum fell 11% and palladium plunged some 30%, impacted by a sharp drop in demand as automobile production was slowed by the shortage of microchips. Nickel fell 1.5% and copper lost 3.7%.

In South Africa, economic growth for Q2 2021 surprised to the upside at 1.2% (q/q annualised) compared to the consensus of 0.7% q/q. However, news was dominated by the July riots sparked by the jailing of Jacob Zuma - National Treasury estimated the resulting damage could subtract around 0.9 percentage points from 2021 GDP growth.

Growth prospects were also hit by the higher lockdown levels imposed as a result of the spiking "third wave" of the coronavirus pandemic. The ebbing of the wave towards quarter-end was a positive sign that vaccinations were making progress, paving the way for a further opening of the economy. At its September MPC meeting, the South African Reserve Bank kept its benchmark interest rate unchanged, but indicated that its first 25bp hike would be coming in Q4, as well as further 25bp increases in each quarter of 2022 and 2023. Importantly, Governor Lesetja Kganyago floated the idea that the SARB may want to reduce its inflation target range from the current 3%-6% to below the inferred 4.5% mid-point target.

Good news came in the form of record-breaking trade surpluses on the back of the rise in commodity prices earlier in the quarter, in turn creating higher-than-expected tax receipts from mining companies. This alleviated some pressure on the government's expected budget deficit, allowing Treasury to cut some planned bond issuance. However, with commodity prices falling later in the quarter, concerns returned over the perilous state of government finances.

SA bonds managed to eke out a 0.4% positive return during the quarter (as measured by the FTSE/JSE All Bond Index), losing 2.1% in September as US Treasuries and global bonds recorded negative returns. The local yield curve continued to flatten as longer-dated bonds outperformed. Meanwhile, SA inflation-linked bonds again outperformed their nominal counterparts as inflation fears gained ground, producing 2.0% (Composite ILB Index), and cash (STeFI Composite) delivered 1.0%.

Finally, the rand depreciated against the major global currencies over the quarter, retracing some of its gains seen earlier in the year amid the higher risk-off sentiment and a stronger US dollar, particularly in September. It lost 5.4% against the US dollar, 2.9% versus the pound sterling and 3.0% against the euro over the three months. This helped boost returns for SA investors with offshore exposure.

Performance

The fund delivered a return of 1.4% (net of fees) for the third quarter of 2021, outperforming its benchmark (the STeFI Composite Index) by 0.5%. For the year ended 30 September 2021, the fund returned 7.2% (net of fees), outperforming its benchmark by 3.4%.

For the quarter, investments in floating-rate instruments, fixed-rate bonds, inflation-linked bonds, SA property and international assets (hedged back into rand), contributed positively to overall fund returns.

Annualised performance	A class	Benchmark	T class	X class	D class
1 year	6.4%	3.8%	6.6%	6.3%	6.7%
3 years	5.3%	5.7%	5.6%	5.4%	5.7%
5 years	5.9%	6.4%	6.2%	6.0%	6.4%
7 years	6.3%	6.5%	-	6.4%	6.8%
10 years	6.9%	6.4%	-	7.1%	7.4%
Since inception	7.5%	6.9%	-	-	-

[1] 12-month rolling performance figure

Sources: M&G Investments, Morningstar & Deutsche Securities

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Strategy and positioning

In the third quarter of 2021 we maintained the fund's offshore allocation by keeping our exposure to US high yield corporate bonds and some dollar-denominated SA government bonds, which we hedged back into rand using a blend of currency futures and options.

We maintained our positioning in SA listed property, which has been the best-performing sector (and asset class) in 2021 thus far, recording a 27.9% return over the nine months to end-September. It also continues to have good long-term growth prospects and while the logistics and self-storage segments have been the most resilient and are performing well, retail is still weak and the office segment even weaker, plagued by high vacancies. We have positioned the fund to hold quality companies with strong balance sheets within our small exposure to the sector.

Our broad view based on earnings reports is that risks in the listed property sector have improved since the beginning of the year, and our holdings within the sector reflect this.

SA nominal bonds held in the fund managed to record a marginal positive return in the third quarter, and our portfolios benefitted from our continued preference for these assets. During the quarter we added to our holdings as nominal bonds' relative valuations became more favourable. We believe nominal bonds remain attractive relative to other income assets and their own longer-term history and will more than compensate investors for their associated risks.

SA Inflation-linked bonds (ILBs) outperformed their nominal counterparts during the quarter which benefitted the fund. The outperformance by ILBs led us to take some profits and purchase nominal bonds during the quarter, as the latter's relative valuation became more favorable. Although we reduced our exposure to ILBs, real yields offered in ILBs are still relatively attractive compared to their own history and our long-run fair value assumption of 2.5%.

Lastly, we remained heavily tilted away from SA cash as our least preferred asset class, since prospective real returns are negative and other SA assets are more attractive on a relative basis.

Contact us

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Application forms

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Sources: M&G Investments, Morningstar & Deutsche Securities