M&G Investments

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M&G Enhanced Income Fund: More flexibility enhances returns

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Flexible income funds like M&G's Enhanced Income Fund have grown to become a very important category for investors looking for lower-risk solutions that also offer the potential for some capital growth. This is particularly true in the current elevated interest rate environment, where these funds can deliver higher returns than usual. Here I share how we at M&G Investments have chosen to deliver our offering in this highly competitive landscape. I will delve into the people, philosophy and process behind the fund, together with an explanation of its objectives. The history of the fund is explored and so too the lessons learned from operating in the ASISA Multi-Asset (MA) Income fund category, including some of the refinements made to the investment process over time. Finally, I will discuss recent macro-economic developments and provide an update on fund performance.

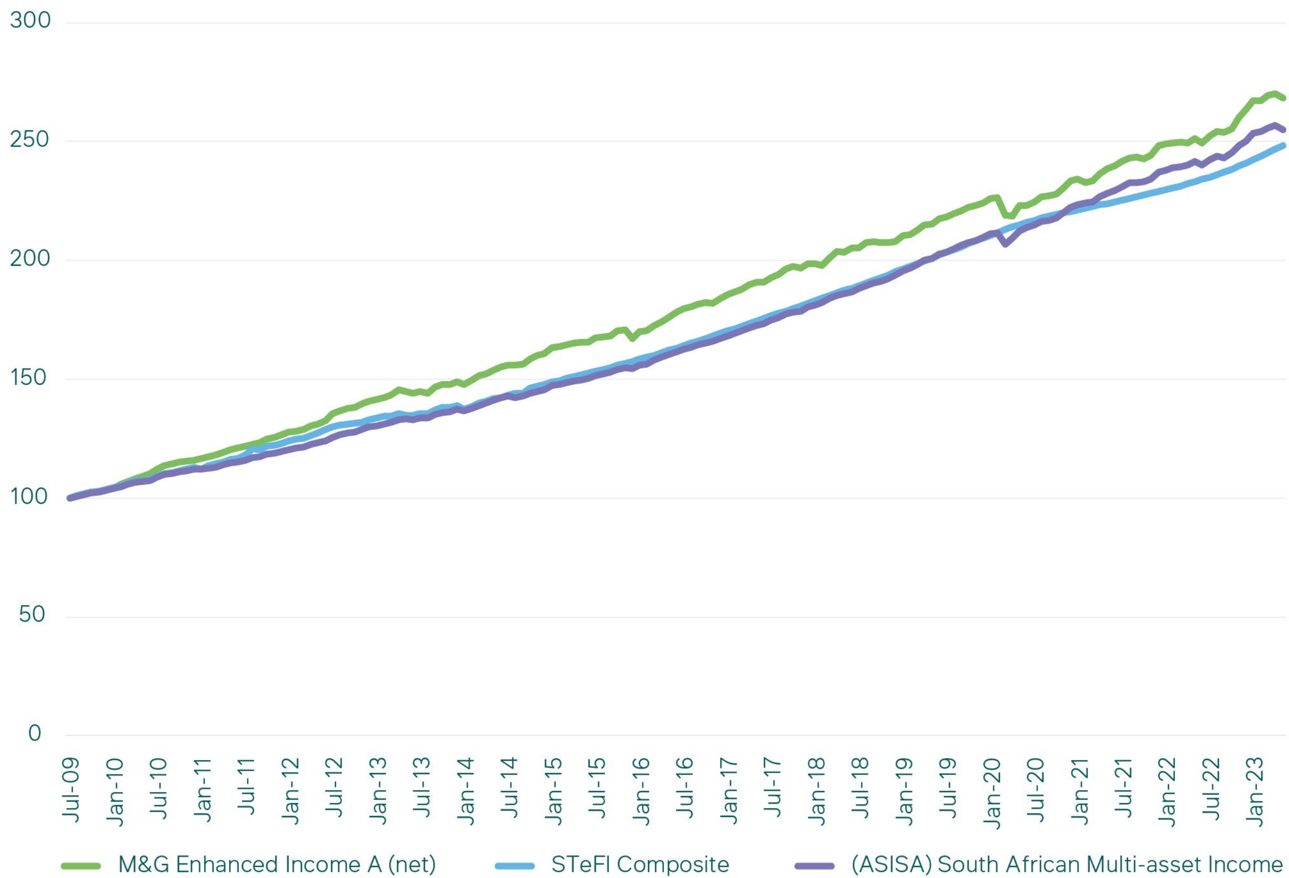
Multi-Asset Income funds on the risk-return spectrum

From an ASISA category perspective, MA Income funds sit one notch lower on the risk scale than MA Low Equity funds, with the primary difference between them being that Low Equity funds are allowed a maximum of 40% equity exposure, whereas Income funds are only permitted up to 10%. Within the MA space, Income funds are the lowest risk category, and are also known as flexible income funds, investing predominantly across the fixed income universe of assets. However, the funds are still expected to deliver total returns above the more yield-focused Interest Bearing (IB) Short Term and IB Money Market categories but with somewhat higher volatility of returns. They aim to achieve the higher total return largely through exposure to various asset classes and/or to higher interest rate risk.

Outperforming its dual return and protection objectives

The M&G Enhanced Income Fund celebrated its 14th anniversary on 1 July this year, and over this time we are happy to report that it has outperformed both its benchmark (the STeFI Composite Index) and its ASISA category average, as shown in Graph 1. The fund's dual objectives are to "maximise total returns in excess of the benchmark over a rolling 36-month period, while seeking to protect capital and reduce volatility through active asset management". In plain English, that means that our experienced team of portfolio managers, David Knee (CIO), Roshen Harry and I look to deliver the highest possible return to our investors in absolute terms over a three-year horizon, while being mindful that we have a further mandate to preserve capital by limiting drawdowns. More specifically, beyond these formal objectives we actively manage the risk the fund assumes in order both to deliver a return of at least 2% above the STeFI Composite Index before fees, and to avoid any capital loss over any rolling 12-month period. To date we have consistently met this latter target, with the fund's lowest annual return being 1.8% after fees in April 2020.

Graph 1: M&G Enhanced Income Fund outperforms over time



M&G Investments, Morningstar data to 29 May 2023

As with all of our funds, the M&G Investments philosophy of being valuation-based, long-term and prudent is enshrined in the M&G Enhanced Income Fund. Our investment process allows us the flexibility to construct the portfolio in favour of the most attractive mix of assets from within the traditional fixed income universe of money market, floating rate notes (FRN's), nominal bonds, inflation-linked bonds (ILB's) and foreign bonds. Furthermore, we can allocate tactically outside of these assets via Interest Rate Swaps (IRS), bond options, listed property, currency and equities. An advantage of being part of an established global asset manager is that we have access to the depth and coverage of the M&G Public Fixed Income Team in accessing foreign bond investments.

In terms of this category, we could be considered conservative as, compared to many other investment managers, we avoid holding structured products such as Credit Linked Notes (CLN's) due to their opaque nature. We do not approve of the cost-plus accrual methodology some use to price these instruments, thereby avoiding mark-to-market pricing and creating an illusion of low volatility. As a consequence, this can periodically lower our fund's yield relative to others. However, we prefer to be very transparent in the risks that the fund assumes and use JSE-published market values for listed assets where we deem these to be fair, and mark-to-market our unlisted money market instruments as well.

Longer-term management lessons

Of course, no fund with 14 years of history can have perfect performance given the ups and downs of financial markets, not to mention the major disruptions caused by the 2013 "Taper Tantrum", December 2015's "Nenegate" drama and the Covid-19 crash. Given the importance of avoiding meaningful drawdowns for investors in this lower-risk fund category, over time we realised that employing a long-term Strategic Asset Allocation (SAA) model in managing the fund was not ideal in that its relative strictness resulted in excess volatility. As such, we refined the process by introducing more flexibility into the asset allocation process, managing it more tactically and adjusting position sizes more frequently. This worked well in the Covid-19 crash, mitigating the fund's drawdowns relative to its peers, and it has subsequently resulted in less volatility.

Weathering more recent storms

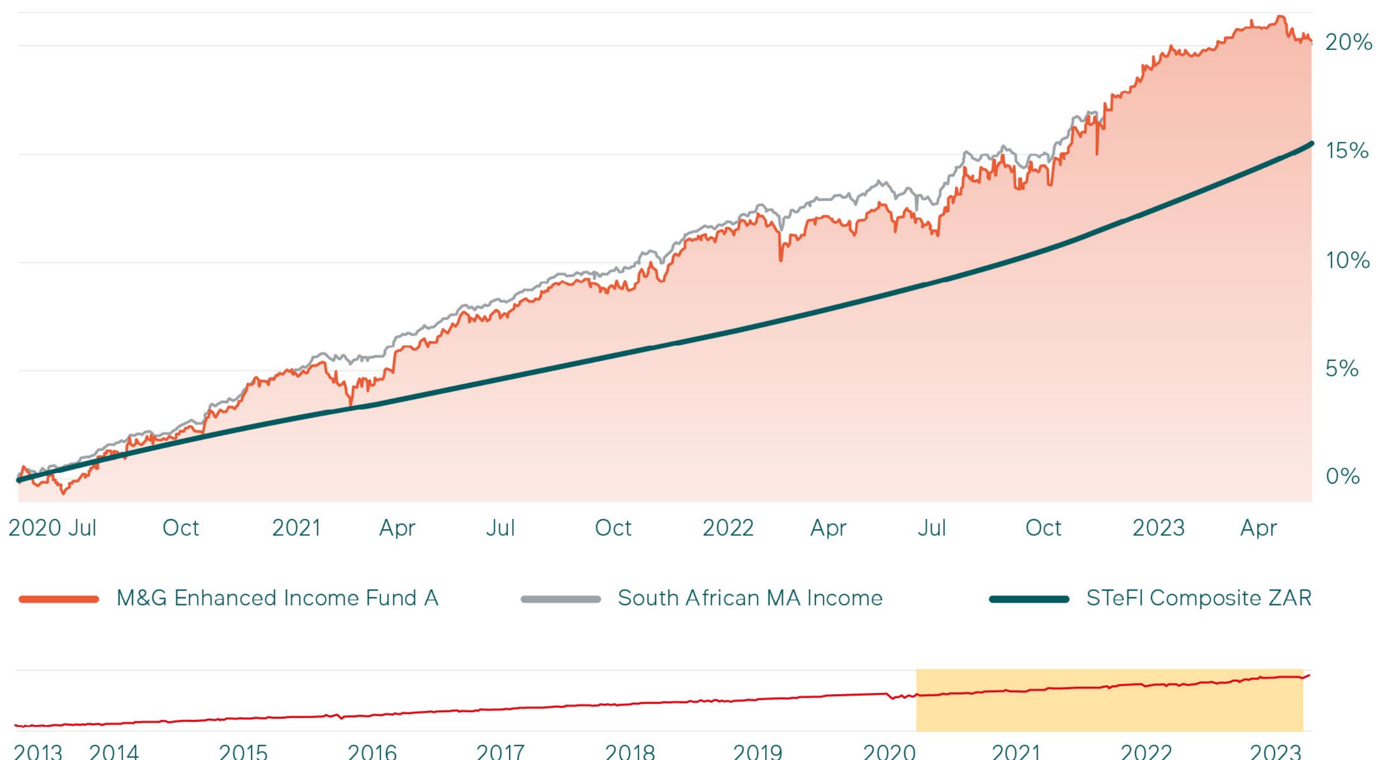
The most recent incident that caused a meaningful drawdown for local fixed income assets was the "Lady R" affair. The comments made by the US Ambassador to South Africa in early May sparked severe sell-offs in both the rand and South African bonds to record-weak levels. Although the M&G Enhanced Income Fund did experience a drawdown, this was relatively well contained because in prior months we had been actively reducing the fund's risk, giving it limited exposure to interest rate risk ahead of the sell-off. And as the geo-political tensions eased in June, both the currency and local bonds recovered, with the fund performing strongly. The incident afforded us the opportunity to increase our interest-rate exposure at very attractive levels at a time when we had capacity to increase risk. Apart from reinforcing that our more flexible approach has been correct, the incident also highlights that outperformance can be obtained both from being underweight risk during bear markets and overweight risk during bull markets. Limiting losses during drawdowns helps to both smooth out an investor's journey and reach the return destination faster.

Fortunately, the volatile macroeconomic backdrop that has prevailed since the onset of Covid-19 has provided ample tactical opportunities for us to add and trim interest rate risk in the fund, adding value for investors. The South African Reserve Bank (SARB) was maintaining a healthy real policy rate and spread versus the US Federal Funds rate going into the Covid crisis. However, with the onset of the crisis, the US Federal Reserve cut rates by 150 basis points (bps) to the zero lower bound, and the SARB followed with aggressive repo rate cuts totalling 325bps to multi-decade lows. The subsequent rise in local inflation saw the real repo rate go into negative territory, and only recently, following 475bps of interest rate increases, has it turned positive again. However, with the Federal Reserve hiking by a total of 500bps thus far, South Africa's repo rate has lagged both the increase in domestic inflation and US interest rates, which has made the rand vulnerable. The forward rate agreement (FRA) market currently anticipates at least one further hike of 25bps by the SARB.

Enhanced performance, but longer-term is key

Looking at the latest fund performance in Graph 2, it is clear that our refinements have borne fruit for investors. For the three-year period to the end of May 2023 the M&G Enhanced Income Fund returned a cumulative 20.3%, ahead of both the category average (20.1%) and the benchmark (15.5%).

Graph 2: Notably improving three-year performance



M&G Investments, Morningstar data to 29 June 2023

Noteworthy was the fact that the fund achieved a top-quartile ranking in its category during calendar year 2022. More recently, the one-year return to end May 2023 was 6.9%, also outperforming the category average (6.5%) and benchmark (5.6%) returns. While this shorter-term performance is most welcome, we understand that longer-term consistency of returns is key for our investors.

Looking ahead, we would expect these volatile conditions to continue for the foreseeable future. In our view, the M&G Enhanced Income Fund is currently well-positioned to take advantage of this. As fund managers we are able to respond tactically and flexibly to the rapidly changing markets, and can exploit the entire spectrum of fixed-income instruments, as well as the best opportunities in listed property, equity and global assets. While we can't expect it to be all smooth sailing, we are confident that we have the right people, philosophy and processes in place such that the fund continues to fully deliver on investor expectations.

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