M&G (Lux) Income Allocation Fund

An update on income as equity dividends are cut

Fund Manager – Steven Andrew

FOR INVESTMENT PROFESSIONALS ONLY

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- *Since the early days of the Covid-19 pandemic, global companies from Royal Dutch Shell to Nissan have cancelled, cut or suspended their payouts, with analysts estimating that dividends could drop by a fifth this year. This would make 2020 the worst year for dividends since the Global Financial Crisis.*
- *As the M&G (Lux) Income Allocation Fund focuses on generating a growing income stream over time, and dividends are an important source of that income, this note provides an update on our current income forecast, what we have been doing in the fund to navigate the current environment and the outlook for the coming months.*

The value and income from the fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested.

Current income forecast

In the current calendar year, the fund has made eight monthly payments amounting to 19.95c per unit. This compares to 23.48c for the same period in 2019, a decline of 15.1%. Looking further ahead, and taking consensus dividend forecasts into account, the current portfolio holdings are expected to pay 28.69c in 2020, versus 34.26c in 2019, a drop of 16.3%. For the fiscal year period – which runs from April to March and is our usual reporting period – income is forecast to fall by about 17.5% compared to the previous year, from 32.57c to 26.87c.

While lower yields from fixed income instruments have played a role in reducing the income received, the cuts and suspensions of equity dividends are a bigger factor. A large component of the less favourable income profile for the fund has been our exposure to the banking sector. European banks have been instructed not to pay dividends for now, while the Federal Reserve has put a cap on the amount of dividends that can be distributed by US banks.

It is worth highlighting that the dividend issues around banking stocks are not their own fault and are not indicative of mismanagement, but have occurred because regulators have taken action. Dividend cuts are not limited to banks; other, non-financial companies have followed suit in order to conserve cash in the uncertain economic environment.

	YTD and calendar-year performance, 5 years (% pa)					
	YTD	**2019**	**2018**	**2017**	**2016**	**2015**
M&G (Lux) Income Allocation Fund EUR A	-8.9	16.3	-8.7	7.9	9.6	-1.8
M&G (Lux) Income Allocation Fund USD A-H	-8.3	19.8	-6.1	9.9	10.5	N/A

Past performance is not a guide to future performance.

The fund is actively managed and has no benchmark. Investors can assess the performance of the fund by its objective to provide a growing level of income and capital growth of 2-4% per annum, both measured over any three-year period.

Source: M&G and Morningstar Inc., as at 31 August 2020, EUR Class A Acc and USD A-H Acc shares, price-to-price, income reinvested, preliminary data. Please note that not all share classes are registered for sale in all countries. Please see the Prospectus for details.

Navigating the current environment

We have taken action to try to mitigate the impact on the fund. This had included increasing the diversity of our equity exposure. Before the sell-off in March, equities were starting to look expensive in many areas, although banking stocks appeared, in our opinion, to offer good value in what seemed to be a healthy economic environment. Significant and widespread share price falls in March presented the opportunity to broaden our equity exposure. We still want to invest in the financial sector as it appears to offer a worthwhile option on the economy recovering faster than currently anticipated, or should virus news improve -- for example, if a vaccine were found. Also, discarding banks and trying to chase dividends seems to us the wrong approach. As stated earlier, it is not just banks that are affected by lower dividends. In our view, looking for attractive opportunities from a potential capital gains perspective while trying to maintain a decent dividend profile should be more fruitful than trying to capture dividends in other areas only to run the risk of encountering dividend cuts or suspensions there as well. Currently, European banks are forecast to pay no dividends this year, but to resume paying them in early 2021.

Corporate bonds, an area where previously the fund had only limited exposure since the valuation of equities was in our view more attractive, are another area that seems promising to us. In terms of dividend payments, equities can be more interesting in 'normal' times, as companies have the possibility of growing their dividends, whereas the coupon payments on corporate bonds are static. However, the economic and market environment is not normal at the moment. As a result of the sell-off in virtually all risk assets earlier in year, corporate bonds became more attractive, in our opinion. In difficult times, dividend payments can be among the first company expenses to be sacrificed. On the other hand, companies will place a higher priority on paying coupons on bonds, as missing a coupon payment is viewed as a default. This would have adverse effects on the company's credit standing and on the conditions in which it could borrow in the future. We increased our exposure to corporate credit in April and again in July.

Holding more corporate bonds also increases the flexibility in our allocation to equities, in our view. One of our central beliefs is that periods of market volatility can present valuable investment opportunities for the longer-term investor. Following their strong rally in recent months, we have reduced our holdings of equities. Not holding the maximum amount of equity allows us to be flexible and tactical if we identify attractive opportunities.

Please remember that investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the fund.

Outlook

We would like to repeat that in our opinion the companies in the fund that have cut dividends this year have not been mismanaged or done anything wrong. They have either been instructed to hold back dividends by their regulator or have decided to do so themselves until they get a clearer picture of the economic conditions. We still believe that there is a fair chance of additional payments when the economic situation normalises. We are encouraged by the fact that some companies that postponed dividends earlier have now resumed their payments as the economy has started to improve and the outlook has become more optimistic.

While the income in 2020 is looking to be smaller compared to the previous year, we stay strongly committed to our approach – trying to have the correct asset allocation in order to grow the capital of the fund while targeting a reasonable yield. We believe this should ultimately result in an attractive total return. Remember, we are still receiving income from holdings of emerging market and peripheral European government bonds, credit and some equities.

We could technically pay income out of capital, but this runs counter to our beliefs. It would fix the income issue temporarily, but would bring negative consequences for future years, in our view. Unless capital can be brought back to the original starting amount, income will fall in subsequent periods. Instead, we believe that looking for attractive investment opportunities – which we currently see in equities, credit and selected emerging market bonds – with the potential for capital growth and a decent yield should help us to generate a growing income stream in the future.

Investing in emerging markets involves a greater risk of loss due to greater political, tax, economic, foreign exchange, liquidity and regulatory risks, among other factors. There may be difficulties in buying, selling, safekeeping or valuing investments in such countries..

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The fund allows for the extensive use of derivatives.

Further risks associated with the fund can be found in the fund's Key Investor Information Document.

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