M&G Insights

Investment Focus - M&G Enhanced Income Fund: Cyclically aware and tactically alert

November 2023

M&G Investments

We are pleased to report that the M&G Enhanced Income Fund recorded a strong outperformance of its benchmark for the 12 months to 31 October 2023, delivering 10.4% versus the STeFI Composite Index's 7.7% return. The fund ranked 5th in its ASISA category out of 116 funds over the past year. How did it achieve this strong performance? We delve into the investment process and provide an illustration of how it worked in practice.

Our team of portfolio managers, David Knee, Roshen Harry and Bulent Badsha look to deliver the highest possible return to investors, while being mindful that they have a further mandate to preserve capital by limiting drawdowns. The investment process allows them the flexibility to construct the portfolio in favour of the most attractive mix of assets, as well as to be tactical. The volatile macroeconomic backdrop has provided ample tactical opportunities for them to add and trim interest rate risk (duration) in the fund, adding value for investors. Fixed income assets by their very nature are highly cyclical, susceptible to both domestic and global inflation and monetary policy cycles. The team pays particular attention to the interest rate cycle of the South African Reserve Bank (SARB). The path of the SARB repo rate, as the base interest rate of the local economy, affects the pricing of all assets along the term structure (yield curve). How the SARB navigates the highly uncertain local and global environment is important for them in managing the Fund, as it influences their asset allocation decisions between holding fixed-rate, floating-rate or inflation-linked instruments, as well as the overall level of duration and currency risk in the portfolio. The hiking cycle saw them reduce fixed-rate risk in favour of floating-rate exposure. They also make a concerted effort to understand the fiscal policy stance adopted by government, as it affects their duration position and government bond exposure. The deterioration in government finances saw them favour the short end of the yield curve.

A good illustration of the process at work would be the "Lady R" drama earlier this year, which caused a meaningful drawdown for local assets. The comments made by the US Ambassador to SA in early May sparked severe sell-offs in both the rand and bonds to record-weak levels, with the All Bond Index losing almost 5%. Although the Fund did experience a small drawdown of 0.6%, this was relatively well contained because in prior months it had been actively reducing risk, giving it limited exposure to duration 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 them the opportunity to increase duration at very attractive levels at a time when they had capacity to increase risk. Apart from reinforcing that a flexible approach was correct, the incident also highlights that outperformance can be obtained both from being underweight risk during bear markets and overweight risk during bull markets.

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