M&G Investments

M&G Insights

M&G Inflation Plus Fund | The benefit of diversification during market volatility

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During periods of volatile markets, such as those experienced in October, the diversification inherent in multi-asset funds has proven its benefits once again. A well-diversified portfolio can help smooth out the ups and downs of the market, offering a more balanced approach to investing. The M&G Inflation Plus Fund is a good example of this strategy in action. In this note, we explore how the investment process delivers even amid challenging market conditions.

The primary objective of the M&G Inflation Plus Fund is to achieve a return of CPI+5% per annum before fees over a rolling 3-year period. To achieve this, the fund typically takes on more exposure to risk assets than many of its peers. As a result, short-term returns may experience relatively higher volatility, reflecting the ups and downs of the economic cycle. While the fund's return target of CPI+5% per annum before fees is ambitious, we believe it's achievable across a variety of economic and financial cycles. This objective is more aggressive compared to many other multi-asset, low-equity funds, which typically aim for CPI+3% after fees. The fund also has a secondary objective: to minimise the risk of capital loss over any rolling 12-month period.

To achieve its return objectives, the portfolio generally maintains a relatively higher allocation to growth assets (currently 37%) such as equities and property, which are associated with higher risk and market volatility. As a result, we recommend investors have an investment horizon of at least three years and are prepared to endure the associated potential price fluctuations.

At M&G Investments, our investment process is forward-looking, and valuation based. We begin by analysing the current valuations of different asset classes to assess their likely returns over the next three to five years and then build our portfolios accordingly. We look to valuations for an indication of what the different asset classes could plausibly deliver in the future. Valuations say very little about prospective short-term returns but have some predictive power for returns over the medium to long term.

Within the fund, we continue to prefer domestic assets over foreign exposure (23.5%). From a valuation perspective, SA equities are coming off a very low base and still seem relatively cheap compared to other markets in our view. On the bond side, our 10-year yield is still pricing real returns well in excess of our fair value assumptions (5.5%+ vs 3% real yields, respectively) and therefore remain one of our key holdings.

Looking ahead at prospective real returns in asset classes, we continue to hold the view that SA equity remains well priced, is compensating investors for risks and is poised to deliver attractive real returns over 8% going forward. Investors in SA government bonds have been well-rewarded for their patience with prospective real returns of almost 6%. Similarly, inflation-linked bonds are priced to reward investors with a good real return of around 5%. SA property delivered outsized returns due to improving fundamentals and earnings upgrades at an underlying stock level.

From a foreign exposure perspective, we still see relative value in foreign equity and believe that selectivity in certain countries remains key. While foreign equity in rand terms has shown some volatility in returns compared to SA equity, this was in large part due to rand fluctuation. We are being appropriately compensated for holding foreign bonds (primarily diversified government bonds). US Treasuries for example not only pay us decent real yields for holding them but tend to hold steady during periods of market shocks.

Over the latest one-year period, the fund delivered 18.3% outperforming its objective by 9.5%, and the sector average return of 16.9%. Since inception, the fund has also outperformed both its objective and the sector average as well as achieving top quartile performance over one and 15 years (all returns in rand; data at 31 October 2024).

While we acknowledge it's difficult for investors, we encourage being patient and remaining invested to reap the rewards of the improved returns that are likely as any recovery takes hold.