M&G Episode Macro Fund

a sub-fund of M&G Investment Funds (5)

Annual Short Report December 2019
For the year ended 31 December 2019

M&G INVESTMENTS

Fund information

The Authorised Corporate Director (ACD) of M&G Investment Funds (5) presents its Annual Short Report for M&G Episode Macro Fund which contains a review of the fund's investment activities and investment performance during the period. The ACD's Annual Long Report and audited Financial Statements for M&G Investment Funds (5), incorporating a Glossary of terms is available free of charge either from our website at www.mandg.co.uk/reports or by calling M&G Customer Relations on 0800 390 390.

From June 2020, we will be publishing an annual value assessment delivered to investors in this fund, including an assessment of our charges and services, and how we compare to our competitors. This will be available at www.mandg.co.uk

ACD

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(Authorised and regulated by the Financial Conduct Authority. M&G Securities Limited is a member of the Investment Association and of the Tax Incentivised Savings Association.)

Important information

The investment objective and policy were changed for the M&G Episode Macro Fund on 14 June 2019.

As mentioned in the shareholder letter on 17 June 2019, we have made changes to the way we charge for M&G funds based in the UK, starting on Thursday 1 August 2019. The annual charge should be simpler to understand and easier to compare with other fund charges. We have combined all the charges that make up the current ongoing charge figure (OCF) into a single annual charge. Only exceptional items such as unforeseen legal and tax expenses, also known as extraordinary expenses, will be excluded from the annual charge. To find out the new annual charge and the OCF which are shown in the Key Investor Information Document (KIID) for the share class(es) you are invested in, visit our website www.mandg.co.uk

Investment objective up to 13 June 2019

The fund aims to deliver a higher total return, with lower volatility on average, than global equities over a rolling three to five year period. There is no guarantee that the fund will achieve a positive return over this, or any other, period and investors may not recoup the original amount they invested.

Investment policy up to 13 June 2019

The fund manager adopts a flexible approach to the allocation of capital between asset classes in response to changes in economic conditions and the valuation of assets. Central to this approach is the identification of episodes, which are periods of time during which, in the fund manager's view, asset prices become over- or under-stated, relative to objective valuation measures, due to the emotional reaction of investors to events. These episodes can exist over both the short and medium term. The short term volatility of the fund may be high.

The fund will typically invest in a variety of equity index futures, currency forwards, interest rate swaps, and other highly-liquid derivatives. The portfolio may therefore comprise a high proportion of cash and near cash, the majority of which is likely to be held in cash deposits. In addition to derivatives, the fund may invest in a range of equities, fixed income and other assets, including collective investment schemes, other transferable securities, deposits, warrants and money market instruments.

Subject to rigorous risk management, the fund is likely to operate with a gross asset exposure in excess of net assets. This will be achieved through the use of derivative contracts, often with a view to increasing diversification.

Investment approach up to 13 June 2019

The managers believe the best approach for achieving the fund objective lies in the flexible allocation of capital between asset classes, guided by a robust valuation framework. In particular, they seek to respond where asset prices move away from a reasonable sense of 'fair' value due to investors reacting emotionally to events. They believe such 'episodes' create opportunities because emotions should be less important than underlying fundamentals over the medium and long term.

The fund is fully flexible and is not bound by any sense of neutrality or benchmark. The fund's investment strategy is likely to involve the use of financial instruments to take short positions, that is, positions that profit from a fall in the price of an asset, or to generate modest amounts of leverage (gain exposure to greater investment than the net asset value of the fund).

Investment objective from 14 June 2019

The fund aims to deliver a total return (the combination of capital growth and income) of at least 4-8% per annum above the 3-month LIBOR over any five-year period, after charges are taken.

There is no guarantee that the fund will achieve a positive return over five years, or any other period, and investors may not get back the original amount they invested.

Investment policy from 14 June 2019

The fund typically uses derivatives to gain exposure to a range of asset classes including equities, fixed income securities, convertibles and currencies, from anywhere in the world. Exposure to these assets may also be gained directly, or indirectly via collective investment schemes (including funds managed by M&G). In addition, the fund may invest in cash and near cash.

The fund may use derivatives to operate with net long or net short exposure to any position or asset class, and at the overall fund level. Consequently, the fund can have net asset exposure in excess of the total net assets of the fund.

Derivatives may be used for investment, portfolio management and hedging purposes.

Investment approach from 14 June 2019

The fund adopts a highly flexible investment approach. It is unconstrained in the allocation of capital in that there is no pre-set asset allocation limits or reference to industry benchmark.

The investment approach combines in-depth research to work out the value of assets over the medium to long term with analysis of market reactions to events to identify investment opportunities. In particular, the fund manager seeks to respond when asset prices move away from a reasonable sense of 'fair' long-term value due to market reactions to events.

The fund does not target a static level of volatility and short-term volatility can be high. The fund manager believes that this investment approach should lead, over five years, to a lower volatility than that of global equity markets (as represented by the MSCI ACWI Index).

Benchmark

Benchmark: 3-month USD LIBOR + 4-8%.

The fund is actively managed. The benchmark is a target which the fund seeks to achieve. The rate has been chosen as the fund's target benchmark as it is an achievable performance target given the fund's investment policy. The target benchmark is used solely to measure the fund's performance and does not constrain the fund's portfolio construction.

Fund information

Risk profile

The fund invests globally in a broad range of assets, including company shares (equities), fixed income securities (bonds), currencies and other assets such as property shares and convertible bonds. The fund is, therefore, subject to the price volatility of global financial and currency markets. Exposure to the different asset classes is typically gained through the use of derivatives.

In association with the use of derivatives, including those instruments not traded through an exchange, collateral is deposited, in order to mitigate the risk that a counterparty may default on its obligations or become insolvent.

The fund is fully flexible and is managed aggressively, although the managers will seek to maximise portfolio diversity wherever possible. However, in cases where the managers believe that the opportunities are limited to a few areas, there may be a higher-than-usual concentration of asset or market exposure. Such strategies may result in higher volatility of the fund's short-term performance.

The blend of assets held in the fund is regularly adjusted depending on where the managers see the most value and to manage risks, including liquidity, credit, currency and market risks. The fund's risks are measured and managed as an integral part of the investment process.

The following table shows the risk number associated with the fund and is based on Sterling Class 'S-H' shares.

Low risk — High risk

Typically lower rewards — Typically higher rewards

1	2	3	4	5	**6**	7

The above number:

- is based on the rate at which the value of the fund has moved up and down in the past and is based on historical data so may not be a reliable indicator of the future risk profile of the fund.
- is not guaranteed and may change over time and the lowest risk number does not mean risk free.
- has not changed during this period.

Investment review

As at 2 January 2020, for the year ended 31 December 2019

Performance against objective

Between 2 January 2019 (the start of the review period) and 2 January 2020, the M&G Episode Macro Fund's Sterling Class 'S-H' and Sterling Class 'T-H' shares delivered a positive total return (the combination of income and growth of capital) of around 14%.

The fund's objective changed on 14 June 2019, in order to provide a clearer explanation of what the fund sets out to do and how it is managed, and also to make it easier to determine whether it has achieved its aim. According to the new objective, the fund aims to deliver a total return of at least 4-8% per year above the 3-month LIBOR over any five-year period, after charges are taken.

Over the 12-month review period and over five years, the fund met its objective, delivering returns that were either above 3-month LIBOR plus 4-8%, or within the range, after charges are taken.*

* For the performance of each share class, please refer to the 'Long-term performance by share class' table in the 'Fund performance' section of the Annual Long Report and audited Financial Statements for M&G Investment Funds (5).

To give an indication of the performance of the fund, the following table shows the compound rate of return, per annum, over the period for Sterling Class 'S-H' (Accumulation) shares. Calculated on a price to price basis with income reinvested.

Long-term performance

	One year 02.01.19 % [a]	Three years 03.01.17 % p.a.	Five years 02.01.15 % p.a.	Since launch % p.a.
Sterling [b]				
Class 'S-H'	+13.8	+3.4	+4.6	+3.9 [c]

[a] Absolute basis.

[b] Price to price with income reinvested.

[c] 3 June 2010, the launch date of the fund.

Please note past performance is not a guide to future performance and the value of investments, and the income from them, will fluctuate. This will cause the fund price to fall as well as rise and you may not get back the original amount you invested.

Investment review

Investment performance

The fund's positive returns in 2019 were primarily driven by its exposure to equities (company shares), with our decisions to increase positions at the end of 2018 and after the 'episode' in summer 2019 (which was a period of significant market weakness) proving beneficial. 'Episodes' are periods when asset prices rise or fall due 'behavioural' influences such as panic or excitement, and which are often characterised by rapid price moves. Such episodes can represent opportunities for the fund as they reverse.

Having started the year with exposure to US government bonds (Treasuries) and adding positions in emerging market government bonds in the first quarter, the fund also partially benefited from the dramatic fall in global interest rates into the middle of the year. However, short positions (which benefit when prices fall) in UK government bonds (gilts) and German government bonds (bunds) delivered negative returns in this environment. In addition, there were modest gains from currency exposures, most notably to the Turkish lira.

After rising interest rates had driven negative returns in almost all assets in 2018, 2019 saw a reversal of this trend. The correlating influence of falling global interest rates – whereby both equities and bonds delivered positive returns – meant that our investment decisions were more about the scaling of equity and bond exposures over the course of the year, than the emergence of more distinctive episodes.

Indeed, the tactical element of our investment approach (that is, the ability to quickly and flexibly scale positions) proved extremely important. As we look back on calendar year returns, it is easy to forget that equity markets generally went sideways between April and October. By responding tactically, and increasing exposure in response to the 'episodic' opportunities that we identified in the fourth quarter of 2018 and in the summer of 2019, the fund was able to capture the key periods of positive return.

Within equity exposures, notable gains came from a position in the US banking sector. We subsequently released profits, cutting exposure to 5% from 15%, as we believe valuations have become less attractive following the price increase.

There were also gains from exposure to a basket of emerging market government bonds, which we established in March 2019 and increased amidst the 'risk-off' behaviour that took hold in August (as investors took refuge in 'safe-haven' assets). This position, like the fund's exposures to high yielding currencies, also benefited from a lower rate environment.

Among the fund's currency positions, material gains were made via exposure to the Turkish lira: a 12% position that had been opened deep in the crisis of 2018, but which has now been reduced to 6% as market sentiment and valuations have become less extreme.

One of the biggest surprises of the year was the extent of yield (which moves inversely to bond price) declines on government bonds across the world. The capital gains seen in parts of the fixed income universe into the summer were staggering. While we had added duration (sensitivity to interest rate changes) via US Treasuries, and subsequently through emerging market government bonds, these were not enough to offset the losses from short positions in gilts and bunds.

Investment activities

The portfolio at the end of 2019 looks very different to the one that started the year, reflecting the dramatic shift in investor perceptions and the global interest rate dynamic.

Amidst the episodic fear that heralded the start of 2019, the fund's overall equity exposure was 74.5%. By the end of the year that figure stood at 27.5%, the lowest level since the post-US election rally in late 2016. This was a reflection of the shift in valuation signals and the unwinding of the behavioural episode that had taken hold before the start of the year. The fund now also has a large position in emerging market government bonds that was not in place a year ago, while the material position in the Turkish lira has been cut in half.

One area where the current portfolio resembles that of a year ago is in the exposure to US long-dated Treasuries. At the start of 2019 the weighting was at 15% of the fund, which provided an important offset to losses from short government bond positions as global bond yields fell sharply into the middle of the year. This position was closed in June, just prior to the sharpest – and most episodic – yield declines, but as these moves have unwound into the end of 2019, a 10% position was re-established in December.

Outlook

Just as it felt emotionally uncomfortable adding to risk prior to the start of 2019, the end of the year offers just as much cause for anxiety. Are we about to see the 'melt up' in all assets as valuations properly adjust to very low rate expectations? Or are markets just as vulnerable to any sign that the global recession fears of only six months ago might have been justified?

Investment review

Our experience suggests that phases of relative calm such as that which has been in place for the last couple of months are often forerunners to big moves, in either direction. Ultimately, however, our key observation is that the irrational behaviour by investors that periodically creates tactical opportunities for our strategy is less evident currently; rather, investors are ‘rationally uncertain’. It is therefore appropriate to be in a more neutral position: backing our longer term value observations, but being in a position to respond to the episodic near-term volatility that will almost certainly emerge. Patient opportunism is key.

As noted above, the tactical element of the approach played an important role that can be easily overlooked from the point of view of calendar year returns. However, with value signals from assets no longer so strong, it seems likely that this tactical element will not only continue to be significant, but also a clear differentiator.

David Fishwick & **Eric Lonergan**
Co-fund managers

Employees of M&G FA Limited (formerly M&G Limited) which is an associate of M&G Securities Limited.

Please note that the views expressed in this Report should not be taken as a recommendation or advice on how the fund or any holding mentioned in the Report is likely to perform. If you wish to obtain financial advice as to whether an investment is suitable for your needs, you should consult a Financial Adviser.

Classification of investments

The table below shows the percentage holding per sector.

as at 31 December	% of fund 2019	% of fund 2018
EQUITIES		
Banks	4.19	12.50
Finance & credit services	0.84	2.58
Equity derivatives		
Equity futures contracts	0.27	(1.31)
FIXED INCOME		
Debt securities		
‘AA’ credit rated bonds	70.78	74.68
‘A’ credit rated bonds	1.98	0.00
‘BBB’ credit rated bonds	2.02	0.00
‘BB’ credit rated bonds	3.90	0.00
Debt derivatives		
Interest rate futures	0.72	0.40
Fixed income portfolio	9.54	0.00
CURRENCY		
Forward currency contracts	(0.48)	1.09
SHARE CLASS HEDGING		
Forward currency contracts for share class hedging	0.34	(0.28)

Financial highlights
Fund performance

Please note past performance is not a guide to future performance and the value of investments, and the income from them, will fluctuate. This will cause the fund price to fall as well as rise and you may not get back the original amount you invested.

The following chart and tables reflect the key financial information of a representative share class, Sterling Class ‘S-H’ (Accumulation) shares. As different share classes have different attributes, for example charging structures and minimum investments, please be aware that their performance may be different. For more information on the different share classes in this fund please refer to the Prospectus for M&G Investment Funds (5), which is available free of charge either from our website at www.mandg.co.uk/prospectuses or by calling M&G Customer Relations.

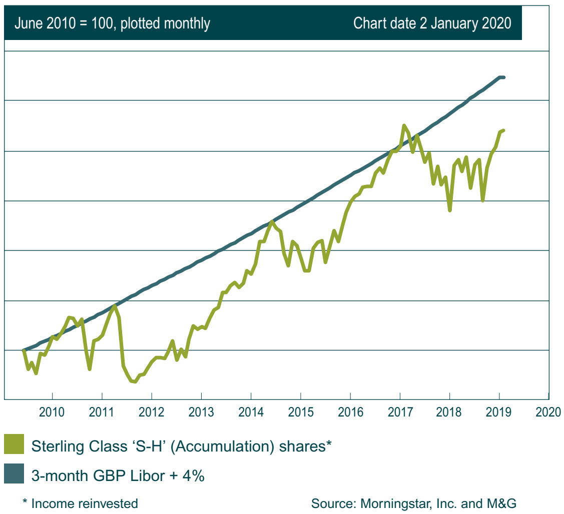
Fund level performance

Fund net asset value

as at 31 December	2019 \$'000	2018 \$'000	2017 \$'000
Fund net asset value (NAV)	153,589	140,472	397,405

Performance since launch

To give an indication of how the fund has performed since launch, the chart below shows total return of Sterling Class ‘S-H’ (Accumulation) shares.



Financial highlights
Fund performance

To give an indication of how the fund has performed during the period the table below shows the performance of Sterling Class 'S-H' (Accumulation) shares.

All 'Performance and charges' percentages represent an annual rate except for the 'Return after operating charges' which is calculated as a percentage of the opening net asset value per share (NAV). 'Dilution adjustments' are only in respect of direct portfolio transaction costs.

Historic yields for the current year are calculated as at 10 January 2020.

Sterling Class 'S-H' Accumulation share performance

The share class was launched on 3 June 2010.

for the year to 31 December Change in NAV per share	2019 UK p	2018 UK p	2017 UK p
Opening NAV	128.34	141.01	129.90
Return before operating charges and after direct portfolio transaction costs	18.06	(9.97)	13.73
Operating charges	(2.70)	(2.70)	(2.62)
Return after operating charges	15.36	(12.67)	11.11
Distributions	(0.92)	0.00	0.00
Retained distributions	0.92	0.00	0.00
Closing NAV	143.70	128.34	141.01
Direct portfolio transaction costs	**UK p**	**UK p**	**UK p**
Costs before dilution adjustments	0.19	0.06	0.05
Dilution adjustments [a]	(0.01)	(0.01)	(0.01)
Total direct portfolio transaction costs	0.18	0.05	0.04
Performance and charges	**%**	**%**	**%**
Direct portfolio transaction costs [b]	0.13	0.03	0.03
Operating charges [c]	1.97	1.93	1.94
Return after operating charges	+11.97	-8.99	+8.55
Historic yield	0.64	0.00	0.00
Effect on yield of charges offset against capital	0.00	0.00	0.00
Other information			
Closing NAV ($'000)	146,821	124,154	154,127
Closing NAV percentage of total fund NAV (%)	95.59	88.38	38.78
Number of shares	77,352,145	75,765,045	80,893,353
Highest share price (UK p)	144.02	145.85	141.34
Lowest share price (UK p)	126.75	126.99	129.91

[a] In respect of direct portfolio transaction costs.

[b] As a percentage of average net asset value.

[c] Following the change in charging structure, you may see variances between the comparative and current year figures.

Financial highlights
Operating charges, performance fees and portfolio transaction costs

We explain below the payments made to meet the ongoing costs of investing and managing the fund, comprising operating charges, performance fees and portfolio transaction costs.

Operating charges

Operating charges include payments made to M&G and to providers independent of M&G:

- **Annual charge:** Charge paid to M&G covering the annual cost of M&G managing and administering the fund and the costs of third parties providing services to the fund. From 1 August 2019, this charge rolls all costs that make up the operating charges into one annual charge.

  For every £1 billion of a fund's net asset value, a discount of 0.02% will be applied to that fund's annual charge (up to a maximum of 0.12%).

- **Extraordinary legal and tax expenses:** Costs that specifically relate to legal or tax claims that are both exceptional and unforeseeable. Such expenses are uncommon, and would not be expected in most years. Although they result in a short-term cost to the fund, generally they can deliver longer term benefits for investors.
- **Investment management:** Charge paid to M&G for investment management of the fund. From 1 August 2019 this charge forms part of the annual charge.
- **Administration:** Charge paid for administration services in addition to investment management – any surplus from this charge will be retained by M&G. From 1 August 2019 this charge is rolled into the annual charge.
- **Share class hedging:** Charge paid to M&G for currency hedging services to minimise exchange rate risk for the share class. From 1 August 2019 this charge is rolled into the annual charge.
- **Oversight and other independent services:** Charges paid to providers independent of M&G for services which include depositary, custody and audit. From 1 August 2019 these charges will be paid by M&G and rolled into the annual charge.
- **Ongoing charges from underlying funds:** Ongoing charges on holdings in underlying funds that are not rebated. From 1 August 2019 charges from underlying funds (excluding Investment Trust Companies and Real Estate Investment Trusts) will be rebated.

Performance fees

Performance fee paid to M&G based on fund performance.

These charges do not include portfolio transaction costs or any entry and exit charges (also known as initial and redemption charges). The charging structures of share classes may differ, and therefore the operating charges and performance fees may differ.

Once the annual charge has been operational for twelve months, operating charges will be in line with the ongoing charges shown in the Key Investor Information Document, other than where there have been extraordinary legal or tax expenses, or an estimate has been used for the ongoing charge because a material change has made the operating charges unreliable as an estimate of future charges.

Portfolio transaction costs

Portfolio transaction costs are incurred by funds when buying and selling investments. These costs vary depending on the types of investment, their market capitalisation, country of exchange and method of execution. They are made up of direct and indirect portfolio transaction costs:

- **Direct portfolio transaction costs:** Broker execution commission and taxes.
- **Indirect portfolio transaction costs:** 'Dealing spread' – the difference between the buying and selling prices of the fund's investments; some types of investment, such as fixed interest securities, have no direct transaction costs and only the dealing spread is paid.

Investments are bought or sold by a fund when changes are made to the investment portfolio and in response to net flows of money into or out of the fund from investors buying and selling shares in the fund.

To protect existing investors, portfolio transaction costs incurred as a result of investors buying and selling shares in the fund are recovered from those investors through a 'dilution adjustment' to the price they pay or receive. The table below shows direct portfolio transaction costs paid by the fund before and after that part of the dilution adjustment relating to direct portfolio transaction costs. To give an indication of the indirect portfolio dealing costs the table also shows the average portfolio dealing spread.

Further information on this process is in the Prospectus, which is available free of charge on request either from our website at www.mandg.co.uk/prospectuses or by calling M&G Customer Relations.

Portfolio transaction costs

for the year to 31 December Direct portfolio transaction costs [b]	2019 %	2018 %	2017 %	Average [a] %
Broker commission	0.11	0.02	0.03	0.05
Taxes	0.03	0.02	0.01	0.02
Costs before dilution adjustments	0.14	0.04	0.04	0.07
Dilution adjustments [c]	(0.01)	(0.01)	(0.01)	(0.01)
Total direct portfolio transaction costs	0.13	0.03	0.03	0.06

as at 31 December Indirect portfolio transaction costs	2019 %	2018 %	2017 %	Average [a] %
Average portfolio dealing spread	0.07	0.00	0.00	0.02

[a] Average of first three columns.

[b] As a percentage of average net asset value.

[c] In respect of direct portfolio transaction costs. Please see the section above this table for an explanation of dilution adjustments.

Contact

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* For security purposes and to improve the quality of our service, we may record and monitor telephone calls. Please have your M&G client reference to hand.

** Please remember to quote your name and M&G client reference and sign any written communication to M&G.

† Please note that information contained within an email cannot be guaranteed as secure. We advise that you do not include any sensitive information when corresponding with M&G in this way.

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