

Annual Short Report November 2013 For the year ended 30 September 2013

M&G Optimal Income Fund

How to contact us



Customer Relations*
0800 390 390



Write to us at:**
M&G Securities Limited
PO Box 9039, Chelmsford CM99 2XG



Our website:
www.mandg.co.uk



Email us with queries:†
info@mandg.co.uk

* For security purposes and to improve the quality of our service, we may record and monitor telephone calls. You will require your M&G client reference. Failure to provide this will affect your ability to transact with us.

** Please remember to quote your name and M&G client reference and sign any written communication to M&G. Failure to provide this may affect your ability to transact with us.

† 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.

INVESTMENT OBJECTIVE, POLICY AND APPROACH

Notes to shareholders

In October 2013, we took the opportunity to clarify the meaning of the term 'total return' within the fund's investment objective and investment policy by adding the phrase '(the combination of income and growth of capital)'. This additional wording does not indicate a change in the way the fund is managed.

Investment objective of the M&G Optimal Income Fund

The fund aims to provide a total return to investors based on exposure to optimal income streams in investment markets.

Investment policy of the M&G Optimal Income Fund

The Fund aims to provide a total return to investors through strategic asset allocation and specific stock selection. The Fund will be at least 50% invested in debt instruments, but may also invest in other assets including collective investment schemes, money market instruments, cash, near cash, deposits, equities and derivatives. Derivative instruments may be used for both investment purposes and efficient portfolio management.

Investment approach

The M&G Optimal Income Fund is a fully flexible bond fund, allowing investment across a broad range of fixed income assets according to where the fund manager identifies value. The investment approach begins with a top-down assessment of the macroeconomic environment, including the likely path of growth, inflation and interest rates. The results of this analysis help inform the fund's duration positioning and its allocation to the various bond asset classes. Individual credit selection is carried out in conjunction with M&G's in-house team of credit specialists, which provides bottom-up analysis of the corporate bond markets to complement the fund manager's views.

There are no restrictions on the amount of government bonds, investment grade bonds or high yield bonds that can be held within the portfolio. The fund may also invest in other assets, including cash, equities and derivatives. Derivative instruments may be used for both investment purposes and efficient portfolio management.

Risk and reward profile*



- The above risk number is based on the rate at which the value of the Fund has moved up and down in the past.
- This risk number is based on historical data and may not be a reliable indicator of the future risk profile of the Fund.
- The risk number shown is not guaranteed and may change over time.
- The lowest risk number does not mean risk free.

The Fund has the above risk number because of the effect of the following risks:

- The value of stockmarket 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.
- Any investment in international companies means that currency exchange rate fluctuations will have an impact on the Fund.
- There is a risk that one or more countries will exit the Euro and re-establish their own currencies. In light of this uncertainty or in the event that this does occur, there is an increased risk of asset prices fluctuating or losing value. It may also be difficult to buy and sell securities and issuers may be unable to repay the debt. In addition, there is a risk that disruption in Eurozone markets could give rise to difficulties in valuing the assets of the Fund. In the event that it is not possible to carry out an accurate valuation of the Fund, dealing may be temporarily suspended.
- **Derivatives** – The Fund may use derivatives for the purposes of meeting the Fund's objective, and protecting the capital value from risk. The Fund may also use derivatives to generate exposure to investments exceeding the net asset value of the Fund. This will expose the Fund to a higher degree of risk and may cause your investment to experience larger than average price fluctuations.

The Fund may take short positions through the use of derivatives which are not backed by equivalent physical assets. Short positions reflect an investment view that the price of the underlying asset is expected to fall in value. Accordingly, if this view is incorrect and the asset rises in value, the short position could involve greater risk due to the theoretical possibility of an unlimited rise in its value.

Some derivative transactions may be entered into directly with an eligible person or institution (a 'counterparty'). There is a risk that the counterparty may not meet its obligations or becomes insolvent which could cause the Fund to incur a loss.

- **Fixed income securities** – Changes in the interest rate will affect the value and the interest earned from the fixed income securities held by the Fund. When interest rates rise, the capital value of the Fund is likely to fall and vice versa.

The value of the Fund will fall if the issuer of a fixed income security held is unable to pay income payments or repay its debt (known as a default). A default, expected default, or downgrading will make a fixed income security harder to sell as its value and income are likely to fall. Fixed income securities that pay a higher level of income usually have a lower credit rating because of the increased risk of default. The higher the rating the less likely it is that the issuer will default, but ratings are subject to change.

- **Liquidity** – In difficult market conditions the value of certain fund investments may be less predictable than normal. In some cases this may make such investments harder to sell at the last quoted market price, or at a price considered to be fair. Such conditions could result in unpredictable changes in the value of your holding.
 - **Emerging markets** – The Fund can invest in emerging markets which tend to have larger price fluctuations than more developed countries. The Fund may encounter difficulties when buying and selling these investments or converting the proceeds of a sale or any income earned back into the base currency of the Fund.
- * Please note that this 'Risk and reward profile' section is based on Sterling Class 'A' shares, the nominated share class.

INVESTMENT ACTIVITIES OVER THE REPORT PERIOD

As at 1 October 2013, for the year ended 30 September 2013

We adjust the positioning of the M&G Optimal Income Fund to reflect changes in our outlook regarding interest rates, credit risk (companies' ability to repay their debts) and changes in relative value among the different fixed interest asset classes.

At the start of 2013, we heavily reduced investments in index-linked gilts – bonds ^[a] issued by the UK government that are designed to protect investors from rising inflation. Index-linked government bonds are different to conventional government bonds because both the

semi-annual coupon payments and the capital repayment are adjusted in line with movements in the Retail Prices Index. Index-linked gilts comfortably outperformed conventional bonds during the first part of the reporting period, and so we believed it was a good opportunity to switch allocation.

One of the key drivers of the fund's performance is the ability to reduce or increase the portfolio's sensitivity to changes in bond yields ^[b], otherwise known as 'duration'. With yields on bonds at historically low levels for much of the review period, we reduced our duration position. Following the market sell-off that began in May 2013, we believed that bonds offered more value, and so slightly increased the portfolio's duration accordingly.

We had lowered the portfolio's exposure to higher yielding corporate bonds ^[c] in 2012 as we considered that, due to strong performance, such bonds offered less value. However, following the market-sell off, high yield bonds looked more attractive and so we increased our allocation.

We are able to invest a portion of the portfolio (up to 20%) in shares if we consider a company's stocks (equity) present a more attractive investment opportunity relative to its bonds. We have increased the portfolio's equity exposure since the start of 2013, initially through positions in stocks such as pharmaceuticals firm AstraZeneca, and more recently in firms such as technology providers Apple and Cisco Systems.

Richard Woolnough

Fund manager

Richard Woolnough is an employee of M&G Limited which is an associate of M&G Securities Limited.

[a] Bonds are loans that are extended by an investor to an issuing entity – private sector firms in the case of corporate bonds and governments in the case of government bonds – in exchange for regular interest payments. The issuer promises to pay the holder the initial value of the loan at the end of the bond's life.

[b] The interest received from a bond as a percentage of its investment cost, current market value or face value.

[c] High yield bonds pay a higher interest rate to compensate for the increased risk that investors might not get back the money that they lent.

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.

FUND SUMMARY

DISTRIBUTION DATES AND FUND FACTS

Distribution type	xd	payment
Interim	01.04.14	31.05.14
Final	01.10.14	30.11.14

	Final distribution		Ongoing Charges Figure ^[b]	
	Inc 30.11.13 ^[a]	Acc 01.10.13 ^[a]	30.09.13	30.09.12
Sterling	p	p	%	%
Class 'A'	1.3512	1.7044	1.41	1.41
Class 'I'	1.6280	2.0936	0.91	0.91
Class 'R'	1.1508	1.1700	1.16	1.17 ^[c]
Class 'X'	1.2112	1.5084	1.66	1.66
Euro	¢	¢	%	%
Class 'A-H'	21.0464	21.0115	1.44	1.47
Class 'C-H'	n/a	26.2962	0.95	0.97
Swiss franc	¢	¢	%	%
Class 'A-H'	n/a	12.9995	1.44	1.46 ^[c]
Class 'C-H'	n/a	15.7806	0.94	0.96 ^[c]
US dollar	¢	¢	%	%
Class 'A-H'	n/a	15.8321	1.44	1.47
Class 'C-H'	n/a	19.4056	0.94	0.98

^[a] The date on which the final distribution will be paid to Income shareholders and credited to Accumulation shareholders.

^[b] The Ongoing Charges Figure is the ratio of the relevant annualised total disclosable costs of each share class from the most recent reporting period to the average net asset value for that share class over the same period.

^[c] The comparative Ongoing Charges Figure shown here is an estimate of the charges, as the share class had not been in existence for a full financial year.

Income accrued from interest-bearing securities is distributed on an effective yield basis.

FUND PERFORMANCE

Performance of share classes

	Net asset value per share as at 30.09.13		Net asset value per share as at 30.09.12		Net asset value % change	
	Inc	Acc	Inc	Acc	Inc	Acc
Sterling	p	p	p	p	%	%
Class 'A'	137.34	175.08	130.24	162.72	+5.45	+7.60
Class 'I'	137.33	179.52	130.21	166.21	+5.47	+8.01
Class 'R'	106.75	109.50	101.22	101.57	+5.46	+7.81
Class 'X'	137.26	172.59	130.16	160.73	+5.45	+7.38

FUND PERFORMANCE (continued)

Performance of share classes

	Net asset value per share as at 30.09.13		Net asset value per share as at 30.09.12		Net asset value % change	
	Inc	Acc	Inc	Acc	Inc	Acc
Euro	€	€	€	€	%	%
Class 'A-H'	16.9369	17.1445	n/a	15.9541	n/a	+7.46
Class 'C-H'	n/a	17.7897	n/a	16.4775	n/a	+7.96
Swiss franc	CHF	CHF	CHF	CHF	%	%
Class 'A-H'	n/a	10.7078	n/a	10.0015	n/a	+7.06
Class 'C-H'	n/a	10.7582	n/a	10.0018	n/a	+7.56
US dollar	\$	\$	\$	\$	%	%
Class 'A-H'	n/a	12.5719	n/a	11.6886	n/a	+7.56
Class 'C-H'	n/a	12.7720	n/a	11.8055	n/a	+8.19

Past performance is no indication of current or future performance and the performance data does not take account of the commissions and costs incurred on the issue and redemption of shares.

The price of shares and the income from them may go down as well as up, and you may get back less than you invested.

PRICES ^[a]

	Calendar year	Income shares		Accumulation shares	
		Highest	Lowest	Highest	Lowest
Sterling (net)		p	p	p	p
Class 'A'	2008	100.58	85.68	105.00	92.15
	2009	115.44	91.30	130.22	98.21
	2010	123.19	115.51	143.45	130.32
	2011	124.16	116.84	149.50	140.86
	2012	134.73	122.93	168.33	148.94
	2013 ^[b]	140.82	134.13	177.77	168.11
Class 'I'	2008	100.68	85.62	105.63	92.68
	2009	115.50	91.37	131.53	98.80
	2010	123.40	115.56	145.41	131.66
	2011	124.30	116.81	152.14	142.89
	2012	134.84	123.02	172.11	151.68
	2013 ^[b]	140.89	134.24	182.04	171.88
Class 'R'	2012 ^[c]	104.76	100.00	105.13	100.00
	2013 ^[b]	109.47	104.29	111.10	104.99
Class 'X'	2008	100.52	85.64	104.61	91.75
	2009	115.35	91.26	129.35	97.74
	2010	123.01	115.41	142.24	129.44
	2011	124.01	116.78	147.95	139.62
	2012	134.59	122.80	166.20	147.35
	2013 ^[b]	140.70	133.99	175.37	165.97

PRICES ^[a] (continued)

Calendar year		Income shares		Accumulation shares	
		Highest	Lowest	Highest	Lowest
Euro (gross)		€	€	€	€
Class 'A-H'	2008	n/a	n/a	10.1154	8.9127
	2009	n/a	n/a	12.5860	9.3930
	2010	n/a	n/a	13.9593	12.6017
	2011	n/a	n/a	14.6457	13.7159
	2012	n/a	n/a	16.4971	14.5909
	2013 ^[b]	17.2540 ^[d]	16.9458 ^[d]	17.4192	16.4754
Class 'C-H'	2008	n/a	n/a	10.3090	9.0671
	2009	n/a	n/a	12.7984	9.6084
	2010	n/a	n/a	14.2832	12.8171
	2011	n/a	n/a	15.0591	14.0445
	2012	n/a	n/a	17.0549	15.0133
	2013 ^[b]	n/a	n/a	18.0427	17.0335
Swiss franc (gross)		CHF	CHF	CHF	CHF
Class 'A-H'	2012 ^[e]	n/a	n/a	10.2963	10.0000
	2013 ^[b]	n/a	n/a	10.8742	10.2833
Class 'C-H'	2012 ^[e]	n/a	n/a	10.3059	10.0000
	2013 ^[b]	n/a	n/a	10.9058	10.2937
US dollar (gross)		\$	\$	\$	\$
Class 'A-H'	2010 ^[f]	n/a	n/a	10.2042	9.9077
	2011	n/a	n/a	10.6859	10.0243
	2012	n/a	n/a	12.0993	10.6538
	2013 ^[b]	n/a	n/a	12.7742	12.0840
Class 'C-H'	2010 ^[f]	n/a	n/a	10.2064	9.9209
	2011	n/a	n/a	10.7540	10.0428
	2012	n/a	n/a	12.2346	10.7300
	2013 ^[b]	n/a	n/a	12.9512	12.2210

^[a] Includes prices from the merging fund up to 2 December 2008.

^[b] To 1 October 2013.

^[c] From 3 August 2012 (the launch date of the share class).

^[d] From 12 July 2013 (the launch date of the income shares).

^[e] From 28 September 2012 (the launch date of the share class).

^[f] From 1 October 2010 (the launch date of the share class).

Past performance is no indication of current or future performance and the performance data does not take account of the commissions and costs incurred on the issue and redemption of shares.

The price of shares and the income from them may go down as well as up, and you may get back less than you invested.

INCOME ^[a]**Interest income per share**

	Calendar year	Interim	Distributed Final	Total	Reinvested
Sterling (net)					
Class 'A'		p	p	p	p
	2008	1.9552	2.1384	4.0936	4.2627
	2009	2.4684	2.3580	4.8264	5.2792
	2010	2.0940	2.2547	4.3487	4.9491
	2011	2.1840	2.0536	4.2376	4.9992
	2012	2.1940	1.7800	3.9740	4.8536
	2013 ^[b]	1.4088	1.3512	2.7600	3.4640
Class 'I'	2008	2.1472	2.3364	4.4836	4.6849
	2009	2.6863	2.5680	5.2543	5.8370
	2010	2.3240	2.4954	4.8194	5.5437
	2011	2.4280	2.2980	4.7260	5.6576
	2012	2.4440	2.0400	4.4840	5.5724
	2013 ^[b]	1.6784	1.6280	3.3064	4.2308
Class 'R'	2012	n/a	0.3600	0.3600	0.3620
	2013 ^[b]	1.2020	1.1508	2.3528	2.3756
Class 'X'	2008	1.8524	2.0416	3.8940	4.0455
	2009	2.4089	2.2540	4.6629	5.0280
	2010	1.9860	2.1330	4.1190	4.6484
	2011	2.0620	1.9280	3.9900	4.6688
	2012	2.0680	1.6520	3.7200	4.4952
	2013 ^[b]	1.2724	1.2112	2.4836	3.0800
Euro (gross)					
Class 'A-H'		€	€	€	€
	2008	n/a	n/a	n/a	48.6910
	2009	n/a	n/a	n/a	56.9317
	2010	n/a	n/a	n/a	59.5036
	2011	n/a	n/a	n/a	59.2216
	2012	n/a	n/a	n/a	59.4475
	2013 ^[b]	n/a	21.0464	21.0464	41.4772
Class 'C-H'	2008	n/a	n/a	n/a	53.9650
	2009	n/a	n/a	n/a	64.4401
	2010	n/a	n/a	n/a	67.1521
	2011	n/a	n/a	n/a	56.6838
	2012	n/a	n/a	n/a	69.0887
	2013 ^[b]	n/a	n/a	n/a	51.5807
Swiss franc (gross)					
Class 'A-H'		¢	¢	¢	¢
	2012	n/a	n/a	n/a	-
	2013 ^[b]	n/a	n/a	n/a	25.4346
Class 'C-H'	2012	n/a	n/a	n/a	-
	2013 ^[b]	n/a	n/a	n/a	30.7962
US dollar (gross)					
Class 'A-H'		¢	¢	¢	¢
	2011	n/a	n/a	n/a	43.0092
	2012	n/a	n/a	n/a	43.6347
	2013 ^[b]	n/a	n/a	n/a	30.4158
Class 'C-H'	2011	n/a	n/a	n/a	48.0417
	2012	n/a	n/a	n/a	49.6064
	2013 ^[b]	n/a	n/a	n/a	37.0792

^[a] Includes income from the merging fund up to 2 December 2008.

^[b] Up to final: ex-distribution date 1 October 2013;
payment date 30 November 2013.

MAJOR HOLDINGS

The top ten holdings at the end of this year and the previous year end are shown below.

	% of fund as at 30.09.13		% of fund as at 30.09.12
Treasury 1.25% 2018 (£)	5.84	Treasury 2.5% IL 2016 (£)	6.47
Treasury 1% 2017 (£)	4.34	Treasury 2.5% IL 2013 (£)	4.55
Treasury 3.75% 2019 (£)	2.50	Treasury 2.5% 2020 (£)	3.86
Treasury 5% 2025 (£)	1.88	Northern Trust Global Fund - Sterling ^[a]	2.52
Treasury 3.25% 2044 (£)	1.86	Treasury 1.875% 2022 (£)	1.57
Treasury 4.5% 2019 (£)	1.18	Germany (Federal Republic of) 3% 2020 (€)	1.43
Treasury 2.25% 2023 (£)	0.87	Treasury 3.75% 2052 (£)	1.36
Microsoft (£)	0.79	US Treasury 0.5% 2017 (\$)	1.29
Verizon Global Funding 5.15% 2023 (\$)	0.79	Treasury 1.25% IL 2017 (£)	1.05
Treasury 4.25% 2027 (£)	0.73	Johnson & Johnson	0.71

^[a] Uncommitted surplus cash is placed into 'AAA' rated money market funds with the aim of reducing counterparty risk.

CLASSIFICATION OF INVESTMENTS

The table below shows the percentage holding per sector.

	% of fund as at	
	30.09.13	30.09.12
Oil & gas producers	2.03	1.63
Chemicals	0.28	0.00
Aerospace & defence	0.18	0.20
General industrials	0.21	0.00
Industrial engineering	0.23	0.00
Industrial transportation	0.19	0.00
Automobiles & parts	0.71	0.00
Tobacco	0.37	0.00
Pharmaceuticals & biotechnology	0.71	1.87
General retailers	0.00	0.35
Media	0.33	0.20
Fixed line telecommunications	0.35	0.28
Mobile telecommunications	0.00	0.30
Banks	3.38	0.00
Non-life insurance	0.66	0.00
Software & computer services	0.88	0.68
Technology hardware & equipment	0.87	0.00
Non-convertible preference shares	0.04	0.06
'AAA' credit rated bonds	22.94	25.53
'AA' credit rated bonds	3.63	5.30
'A' credit rated bonds	12.11	16.24
'BBB' credit rated bonds	24.70	23.20
'BB' credit rated bonds	9.50	11.28
'B' credit rated bonds	5.65	5.87
'CCC' credit rated bonds	0.53	0.78
'CC' credit rated bonds	0.06	0.00
'D' credit rated bonds	0.01	0.00
Bonds with no credit rating	6.22	1.43
Forward currency contracts	0.70	(0.52)
Interest rate futures contracts	(0.31)	(0.05)
Credit default swaps	0.87	0.24
'AAA' rated money market funds ^[a]	0.50	2.52

^[a] Uncommitted surplus cash is placed into 'AAA' rated money market funds with the aim of reducing counterparty risk.

OTHER INFORMATION

The information in this report is designed to enable shareholders to make an informed judgment on the activities of the sub-fund during the period covered by the report and the results of those activities at the end of the period. For more information about the activities and performance of the sub-fund during this and the previous period, please contact the Authorised Corporate Director (ACD).

Short Reports

This Short Report is issued in accordance with the requirements of the Collective Investment Schemes sourcebook as issued (and amended) by the Financial Conduct Authority. This Short Report does not contain the Financial Statements of the M&G Optimal Income Fund, and it is unaudited.

Investment Report and Financial Statements

A copy of the ACD's Annual Investment Report and Financial Statements for the M&G Optimal Income Fund, which incorporates the fund's annual investment report and audited financial statements is available free of charge on request from our website at www.mandg.co.uk/reports or by calling M&G Customer Relations on 0800 390 390.

Authorised Corporate Director

M&G Securities Limited, Laurence Pountney Hill,
London EC4R 0HH Telephone: 0800 390 390

(Authorised and regulated by the Financial Conduct Authority)

Investment Manager

M&G Investment Management Limited, Laurence Pountney Hill,
London EC4R 0HH Telephone: 020 7626 4588

(Authorised and regulated by the Financial Conduct Authority)

Fund manager

Richard Woolnough (an employee of M&G Limited which is an
associate of M&G Securities Limited)

Registrar

International Financial Data Services (UK) Limited,
IFDS House, St. Nicholas Lane, Basildon, Essex SS15 5FS

(Authorised and regulated by the Financial Conduct Authority)

Depositary

National Westminster Bank Plc, Trustee & Depositary Services,
Younger Building, 3 Redheughs Avenue, Edinburgh EH12 9RH

(Authorised and regulated by the Financial Conduct Authority)

Independent Auditors

PricewaterhouseCoopers LLP,
7 More London Riverside, London SE1 2RT

M&G is a member of the Investment Management Association and of
the Tax Incentivised Savings Association.

The Instrument of Incorporation can be inspected at our offices or at
the office of the Depositary.

M&G Securities Limited is authorised and regulated by the Financial Conduct Authority
and provides investment products. The company's registered office is Laurence
Pountney Hill, London EC4R 0HH. Registered in England number 90776.