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M&G Credit Income

MGCI offers an exceptionally high yield from a portfolio of high credit quality...

Update
29 March 2024

Overview

M&G Credit Income (MGCI) offers an exceptionally high yield without taking on the credit risk that most bond funds would have to do in order to achieve this – and without the use of gearing. Manager Adam English is able to do this thanks to the exceptionally flexible remit, which allows him to invest across the more complex and illiquid areas of the credit markets, including private debt, bringing the full weight of M&G's institutional expertise and resources to bear in a rare mass-market vehicle. The portfolio is highly diversified across loans, asset-backed securities and private placements, not to mention the more well-travelled fixed-income sectors.

MGCI is currently delivering a handsome yield of 9.3%. The portfolio is c. 75% invested in floating-rate debt, and with the interbank rate SONIA at 5.2%, this is a major contributor. Roughly half the portfolio is in private debt, and Adam is looking for opportunities to add in this segment, with spreads on public debt looking unattractively narrow. However, he is being selective, and this, along with a recent acceleration in repayments of private debt in the portfolio, means the weighting has been slow to rise. In the meantime, higher-quality tranches of asset-backed securities (ABS) and collateralised loan obligations (CLOs) are offering attractive yields versus corporate bonds of worse credit quality.

Adam has a **Gearing** facility on hand, which allows him greater flexibility to take advantage of opportunities as they come up, but it is currently undrawn and the yield on offer is from an ungeared portfolio, unlike many of the other high yields in the investment trust space.

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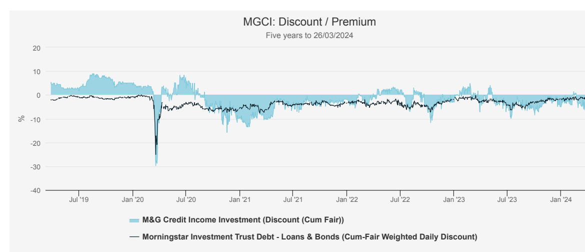
Key Information:

Price (p)	92.3
Discount/Premium(%)	-3.82
OCF (%)	1.28
Gearing (%)	0
Yield (%)	8.6
Ticker	MGCI
Market cap (£)	130,070,000



Kepler View

Arguably, the current economic situation of high rates and positive economic growth is the sweet spot for MGCI's strategy. High rates boost the yield achieved on the portfolio and positive growth means companies are able to fund their debt comfortably. Adam is able to generate an exceptionally high yield without taking too much risk: in credit, in complexity or in duration. A slow decline in rates would see a slow decline in income earned on floating-rate debt, but Adam is likely to have the ability to increase risk to earn extra spread, assuming this is an orderly and slow decline. On the other hand, a sharp cutting cycle in the major developed economies following a rapid deterioration of economic data would be negative for the portfolio, although this would largely be felt in relative rather than absolute performance due to the low duration, given the high credit quality of the portfolio. However, this seems like an unlikely scenario, given the current state of the US and UK economies, and in our view MGCI looks set to deliver high returns from a relatively low-risk portfolio for some time to come.

We think MGCI is a highly attractive option for those seeking to earn a high income at the current juncture. The exceptionally high yield is generated from a portfolio of investment-grade quality. Moreover, Adam has a number of levers to pull to boost the income further should market conditions see yields in higher-quality debt fall.

BULL

- High yield linked to interest rates, with average investment-grade quality credit
- Offers access to private debt markets, providing attractive risk/return characteristics and diversification
- NAV should prove resilient due to many defensive characteristics

BEAR

- Complexity makes it harder for investors to understand exposures
- Limited capital gain potential, including from duration
- Rate cuts will reduce portfolio income, absent offsetting investment decisions

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Portfolio

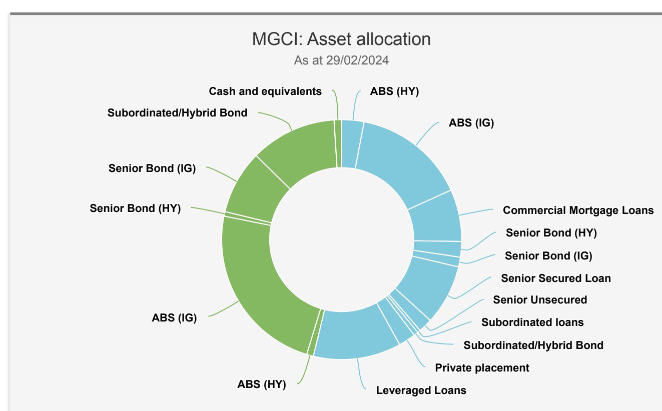
M&G Credit Income (MGCI) is designed to offer a high income linked to interest rates, using the flexibility of investing across public and private fixed-income markets to do so. As MGCI is a closed-ended fund, MGCI's manager, Adam English, can invest substantial proportions of his portfolio in the less liquid parts of public markets, and with MGCI his remit is to invest in private markets too, broadening substantially the investment universe and bringing the attractions of a typically institutional market to the average investor.

A critical strength of MGCI's proposition is that Adam can generate a high income in other ways than simply taking more credit risk. The trust is paying out an exceptionally high yield of over 9% annualised, but from a portfolio which is c. 80% invested in investment-grade quality debt. One reason is the high exposure to floating-rate instruments. These pay a coupon linked to the relevant base rate, which means that as interest rates rise so does the coupon paid. A security which was paying c. 2.5% in 2021 could easily be paying c. 7% today, so sharp has been the rise in UK interest rates. A limited number of bonds are issued with floating rate coupons, but Adam can also invest in asset-backed securities and loans, both of which are overwhelmingly floating-rate asset classes.

Additionally, investing in the private debt markets tends to bring more yield per unit of notional credit risk. This is a diverse universe but it essentially requires investors to take on more responsibility for scrutinising borrowers and deals, as they haven't been through the processes required to offer debt to the public markets. This 'complexity premium', means that those large institutional investors like M&G that can do this work can earn higher yields from lending to stronger companies. Indeed, companies may have public debt trading at narrower spreads than their private debt. Private debt is also typically much less liquid, and this itself can add to the yield on offer. MGCI can invest across a full spectrum of such opportunities, from relatively conventional bond and loan arrangements to directly originated debt for special purposes. For example, borrowers might approach M&G and other institutional investors to help fund a special project or provide leasing financing for specialist equipment. As one of the largest fixed-income investors in the country, M&G has a broad team across relevant subsectors which allows it to take the extra risks in originating such deals and earn the extra yield (see **Management**). Private debt markets are overwhelmingly floating rate too, and MGCI's total exposure to this debt is high at 75%, and has been at this level consistently in recent years.

Adam has full flexibility to invest the portfolio across these parts of the market, and does so in pursuit of generating a high yield with low NAV volatility. Currently his exposure to private debt is fairly low. As of the end of January, c. 46% was in public debt and just 54% in private debt. This is down from 57% a year earlier. This is largely due to repayments increasing in the second half of 2023. While Adam is looking to add in this space, he is being selective amidst a market that is seeing strong investor interest but still offers a healthy illiquidity premium. He finds spreads in public debt markets to be narrow, and therefore is looking to reduce holdings there and add to private assets. As such, we would expect the allocation to rise in coming months. In the meantime, high rated ABS and CLOs have taken a greater allocation of capital. These currently offer higher yields than corporate bonds of lower credit quality, indicating how tight the latter market has become. Some of the exposure here is through a daily-dealing fund, which offers excellent liquidity to MGCI.

Fig.1: Asset Allocation



Source: M&G

This latter positioning in ABS has contributed to a high average credit quality versus history and target. While the objective is to keep at least 70% of the portfolio in investment-grade quality debt, the current figure is ten percentage points higher. To fund the purchase of these ABS, Adam has been selling some lower-rated debt. Assets sold includes some property-related debt bought back in 2022 when interest rates caused yields to widen substantially. That summer, Adam aggressively bought the debt of Scandinavian REITs, thinking the spreads had widened excessively, and the portfolio has enjoyed the benefits of a re-rating, with Adam now banking the profits made. This is a good example of what Adam is trying to do with the portfolio: taking advantage of short-term overreactions and mispricings across the full spectrum of the debt market. One of the ABS that has been bought is a security backed by UK student loans. This is a very seasoned portfolio of loans made under an earlier student-loans programme, with an RPI plus 1.5% coupon (i.e. inflation-linked). Adam has held some of it since launch, but was able to add to this on a c. 15% yield, indicative of the extraordinary opportunities that can occasionally be found in the more illiquid parts of the debt markets. M&G's internal analysts rate the security A (i.e. high investment grade) and the debt was bought from an internal seller in M&G looking to reposition a portfolio. The debt is administered by HMRC, making it very reliable, and Adam

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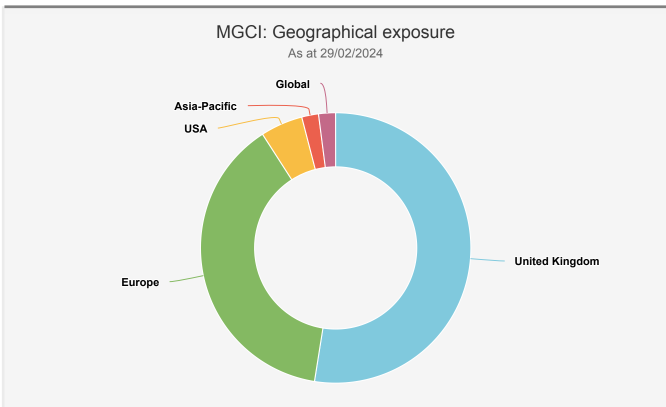
says it has outperformed even the expectations he had for it, with fewer students being unable to pay than feared.

It is worth noting that Adam's approach to tactical positioning is based on where he sees relative value rather than a macroeconomic view. That said, an assessment of value has to consider the direction of travel for markets. In Adam's view, the market got ahead of itself towards the end of last year in expecting multiple rate cuts, and indeed expectations have softened in early 2024. Spreads are pricing in a soft-landing scenario, which, whether this is likely or not, means they don't offer much compensation for credit risk. Nonetheless, Adam does expect defaults in high yield to tick up as the impact of higher rates and sluggish economic growth in Europe feed through, and investors should be looking for more spread in such an environment rather than less. As such, the majority of the portfolio's allocation to high yield is in private assets, where spreads are wider and where bilateral arrangements allow for stronger lender protections (covenant packages). The portfolio has a good record when it comes to defaults. The five-year cumulative default rate sits at 1.32%, which compares to 1.5% for the BBB universe. Default can be a hazy concept at times, and this includes unrealised and realised losses from positions, and as such the true percentage could end up being lower after the full process completes. M&G has a large debt-restructuring team who can work with borrowers to maximise their returns from positions that run into trouble, and this is in our view a key backstop for a manager investing in the complex securities Adam does for MGCI.

One of the key risks with fixed income is duration. By investing predominantly in floating-rate loans, the duration of the portfolio is kept very low. Adam will also use futures to reduce duration at times and as of the end of February the portfolio's duration was 1.3 years. This means there is very little price decline to be expected if interest rates rise, but of course it means the portfolio won't benefit to the same extent as a higher-duration portfolio if rates are cut. A low duration also contributes to less volatile NAV movements.

Fig.2: Geographical Breakdown



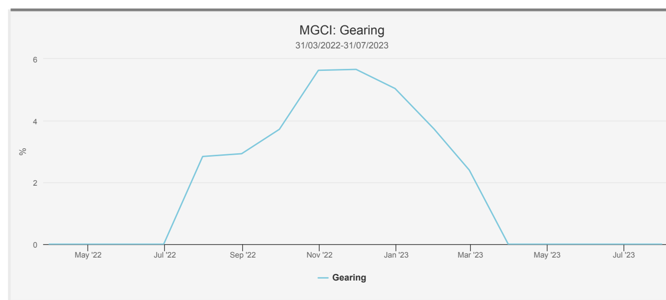
Source: M&G

MCGI is geographically diverse, Adam being able to invest globally. A little over half the portfolio is invested with borrowers domiciled in the UK, and there are investments spread across Europe, the USA and elsewhere. Currencies are hedged back to sterling, which can reduce the yields on offer depending on the interest-rate differentials, but the broad geographic spread adds to the diversification in the portfolio. Allocations are based on stock-specific relative value, like allocations between sectors, rather than based on top-down decisions.

Gearing

MGCI has a gearing facility, although it has been sparingly used. Unlike many trusts that offer a high dividend yield, Adam doesn't have to gear up to generate it, given the generous yields on offer in his investment universe. This is advantageous in that gearing also raises the volatility of the NAV. The trust has a £25m revolving credit facility, which is intended to allow him to take advantage of attractively valued assets when they arise, and to manage liquidity if he wishes to sell private assets and invest the proceeds before the deals have completed. Adam drew down some during the summer of 2022 and again in the market disruption caused by the Truss/Kwarteng mini-budget. This gearing has since been traded away and the portfolio has been ungeared ever since. The current market environment sees high yields available for relatively little credit risk, while macroeconomic risks remain. As such, we understand Adam doesn't see the need to take on gearing.

Fig.3: Gearing



Source: M&G

Overall, MGCI is intended to be a low-risk, low-volatility product, so we would expect gearing to be modest and cautiously applied. That said, if fully drawn down, the gearing would amount to c. 18.7% of the NAV at the time of writing, and the articles of association allow borrowings of 30% of NAV at the time of drawdown, even if the board has stated it does not expect it to exceed 20%. The trust pays SONIA plus 1.30% on any drawings. MGCI pays 0.3% on any undrawn funds.

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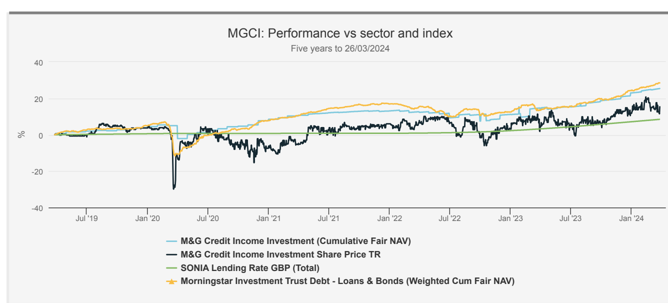
Performance

MGCI is an income fund, and the vast majority of the returns should come from dividends. That said, given how high the income has been, total returns have been pretty attractive since launch. The NAV total return since launch has been 26.1%. To put this in context, the FTSE All Share has delivered a total return of 35.8% over the period. MGCI's NAV, meanwhile, has been much less volatile than the equity index. Over five years the trust has delivered a NAV total return of 25.4% versus a weighted average of 28.5% for the Morningstar Debt – Loans & Bonds sector, with lower volatility as the chart below illustrates.

Fig.3: Performance Over Five Years



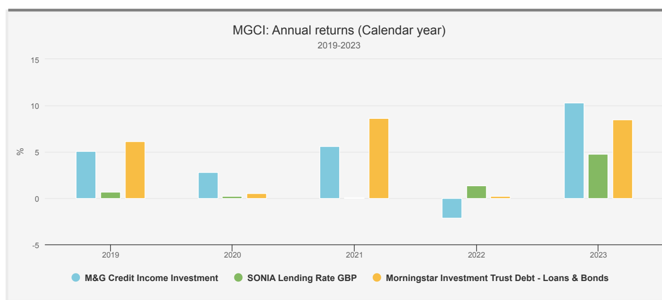
Source: Morningstar

Past performance is not a reliable indicator of future results.

The key factor behind the low volatility of the NAV, and behind the high yield, is that most of the portfolio is invested in floating-rate instruments. Floating-rate assets have very low duration, in contrast to the typical fixed-rate corporate bond or government bond. The NAV drawdown over 2022 was therefore limited. The sterling high yield index was down c. 18% peak to trough in the bond sell off, on a total-return basis, while MGCI's NAV TR was only down c. 5%. Conversely, rate cuts would see limited gains in the value of floating-rate instruments compared to fixed-rate bonds. The Morningstar Debt – Loans & Bonds sector graphed above contains a number of funds invested in high-yield bonds, generally fixed rate, and so the higher volatility in the total returns evident in the chart above reflects largely extra duration, as well as the fact that MGCI declares a NAV each month while many of the peers publish a daily NAV.

Below we show the annual returns over the past five years. Having been down modestly over 2022, MGCI delivered an outstanding return of 10.3% in 2023. While it appears the sector didn't take losses, that is a quirk of the sell-off's timing, as the performance chart above indicates. MGCI's returns were mostly thanks to dividends, with 8.25p paid per share during the year.

Fig.4: Returns



Source: Morningstar

Past performance is not a reliable indicator of future results.

The prospective yield of 4% of NAV plus SONIA equates to 9.2%, given where the interbank rate is, SONIA having risen from 3.4% to 5.2% over 2023. It is important to note that this high yield is not being generated by investing in High Yield – the portfolio is overwhelmingly of investment-grade quality. Indeed, Adam's approach to sector and stock selection is also fairly defensive. It is interest rates that are delivering this exceptional yield, as well as the extra income on offer from investing in specialist areas of the debt market. Adam's view is that investors aren't being compensated for taking on additional credit risk at the moment. He notes that high-yield spreads have come in, meaning that he is happy to take some of this risk off the table and stick with investment-grade quality debt, for example A or AA rated asset-backed securities. While he acknowledges the possibility we will see rate cuts later in the year, which would mechanically lower the yield generated by the portfolio, he notes that expectations have been pushed back considerably over recent weeks. In our view, MGCI looks likely to be able to deliver an exceptionally high yield for some time to come, particularly given the fact Adam has the option to take more credit risk or go into higher yielding private debt to offset any modest base-rate cuts.

As at 31/01/2024, the cum-income NAV was 97.19p. Subtracting the latest 2.14p quarterly dividend gives 95.05p, while there is one month's worth of income also to consider. This is down from 99.94p (ex. Income) at the start of 2022, reflecting largely the fall in the price of publicly traded bonds seen over 2022 as interest rates were hiked substantially. It is key to note that as a closed-ended fund, MGCI is perfectly capable of holding fixed-income assets until maturity, meaning that if they are bought below par there is a baked-in capital gain, absent default. However, if they are bought above par, then losses may be realised. We can't deduce what proportion, if any, of the portfolio was bought above par, but we do note that MGCI experienced mark-to-market losses during the initial coronavirus crash, but the NAV later regained its pre-crisis levels.

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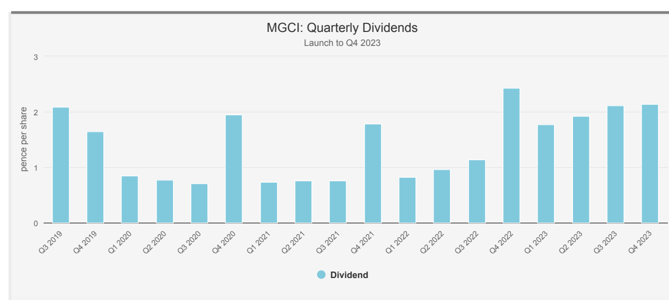
Dividend

The key attraction of MGCI is its ability to pay a high dividend that is linked to interest rates, meaning it rises as the Bank of England base rate does. Annualising the last quarterly dividend, the historical yield is 9.2%, which would be the highest in the AIC Debt – Loans & Bonds sector. MGCI's peers in this sector mostly generate their yields by taking extra credit risk, and indeed by gearing up, whereas MGCI has an investment-grade quality portfolio and no **Gearing**.

Since the start of the 2023 financial year the dividend policy has been to pay out SONIA plus 4% of NAV on a quarterly basis. SONIA, an interbank lending rate, moves essentially in lock-step with the Bank of England base rate. MGCI can commit to linking its dividend to rates in this way as it predominantly invests in floating-rate assets itself. Given the dividend policy, there are two moving parts which affect next quarter's dividend: SONIA and the NAV. SONIA has been at c. 5.2% since the base rate was raised to 5.25% last August, and there are limited prospects for rates to be cut until the summer at least (using official forecasts). While modest rate cuts this year are a realistic possibility, Adam has the ability to take on more risk and buy debt of lower credit quality to boost the income being generated. Additionally, we note that expectations for rate cuts this year have already been tempered since Q4 last year, and rates staying higher for longer seems more likely than it did. Nevertheless, should we see rate cuts, the yield on the trust could decline, while it will not see the gains in the fair value of the portfolio that a conventional, fixed-rate portfolio would.

We think it is an important dynamic to note that the real yield on MGCI is now exceptionally high. With UK CPI falling to 4% YoY in February, MGCI's real yield is around 5.2%. In fact, low inflation, high interest rates and an economy that is not facing a significant recession is arguably the ideal scenario for MGCI, for as well as the effect on real yields, default rates should remain very low and credit spreads supported. We think this is a compelling hedge against a high-interest-rate environment continuing for longer than expected, as well as an attractive income stream in itself.

Fig.5: Dividends



Source: MGCI

Management

MGCI is managed by Adam English, who has been lead manager since May 2020, having been deputy manager from launch in November 2018 until then. Adam has over two decades of experience working in credit markets for M&G, as well as earlier industry experience. In addition to managing MGCI, he works as a fund manager for Prudential's Life and Annuity funds. Adam's deputy managers are Robert Whitten, who is the lead fund manager for the Life and Annuity funds, and Yiu-Wai Cheung, another fund manager on the Life and Annuity funds team.

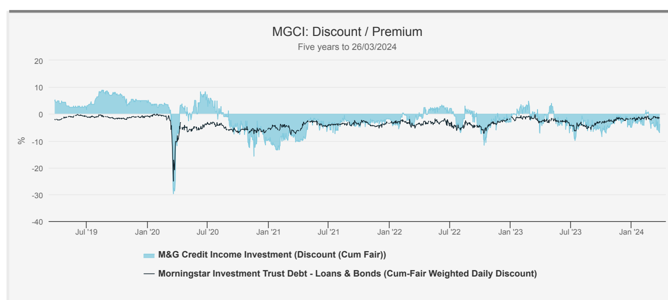
One of MGCI's attractions is the extensive fixed-income team at M&G. Adam is able to draw on the research of analysts in the mainstream fixed-income markets as well as those covering complex, illiquid or private assets, typically the preserve of the institutional investor. This includes a team dedicated to private credit, as well as teams working on leveraged finance, real-estate finance, project and infrastructure finance, and a restructuring team, which can be valuable if any borrowers fall into difficulty. M&G has the scale to be able to devote analysts to these niche areas even when the valuations on the whole sector seem unappealing, which means when opportunities do arise, they have an advantage in being able to get involved swiftly and with confidence.

Adam 'bids' for the investment ideas generated by these teams, and MGCI receives pro-rata allocations alongside other internal M&G clients. The pro-rata policy, whereby all bidders at the winning price receive an allocation, means that although the trust is relatively small within the context of the M&G machine, it has the same access to M&G's deal flow as much larger funds that M&G manage.

Discount

MGCI has traded close to par since the introduction of a discount-control mechanism in April 2021, which seeks to keep the shares trading close to NAV via the use of buybacks and share issuance, passing on to shareholders the benefits of a relatively stable NAV. Since the DCM was established, the discount has averaged 2.4%. At the time of writing it is 3.8%, although we note that in recent weeks the shares have traded above par and the board has issued shares. It is worth bearing in mind that MGCI publishes a monthly NAV, which means there is some uncertainty around the exact discount between NAVs. While we think the DCM is positive, in our view the rates environment and the high yield delivered by the trust are the key reasons that the discount has remained narrow. A yield of c. 9% at the time of writing is highly attractive, particularly considering the portfolio has less credit risk than would be required to get that yield in conventional bond markets.

Fig.6: Discount



Source: Morningstar

The board is currently required to present, prior to the 2028 AGM, proposals for a liquidity window that will offer shareholders the opportunity to exit at NAV less costs. This could work as a discount-control mechanism as the date draws closer. Shareholders voted overwhelmingly last year to push the year this was required out from 2024. We note M&G owns c. 27% of the shares, with four other shareholders owning c. 20% between them and no other shareholder owning more than 3%.

Charges

MGCI's latest ongoing charges figure (OCF) is 1.28%. This includes a management fee of 0.7% of NAV and compares to an average for the AIC Debt – Loans & Bonds sector of 1.21%. Any management fees on M&G funds, such as the European Loans Fund, that MGCI invests in are waived, although the manager does receive half of any arrangement fee charged by MGCI to investee companies. The latest KID RIY is 1.32%, although we would caution that methodologies may vary.

ESG

ESG factors are considered where they have a material impact on risk or return, and investment teams take a long-term view of their investments, which increases the significance of ESG factors. The investment teams take the view that ESG risks frequently develop over the long term. The only hard exclusions are thermal coal and cluster munitions, with M&G preferring to focus on supporting companies transitioning to more sustainable ways of operating, rather than excluding investments. M&G reports extensively on its **responsible investment policy** at firm level on its website. ESG principles are incorporated into the investment decisions as detailed in the annual report, and M&G is a signatory to the United Nations Principles for Responsible Investment (UN PRI).

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