A guide to high yield floating rate notes

Seeking protection against rising interest rates and inflation

M&G Public Fixed Income team

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- High yield floating rate notes (HY FRNs), also known as floating rate bonds, are a growing subset of the global high yield (HY) bond universe. Their main potential advantage over traditional HY bonds is their floating rate cash payments (coupons), which generate income that moves in line with interest rates and potentially reduces the risk of capital loss in rising rate environments due to their minimal interest rate sensitivity.
- HY FRNs could also offer more defensive characteristics than traditional HY bonds, in our view, with lower market volatility and a higher proportion of bonds ranked higher in the capital structure. In managing our HY FRN strategy, we seek to further reduce potential risks and increase diversification relative to the benchmark index.
- As with regular HY bonds, HY FRNs also generate higher potential income than their investment grade counterparts, which can help to protect against inflation eroding the value of future cashflows. However, as high yield debt is riskier than debt with better creditworthiness, a selective investment approach is required to mitigate the additional risks.
- Despite being smaller than the global HY bond market, HY FRNs are liquid securities and daily dealing can be maintained, even in stressed market conditions.

The value and income from a fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested.

Income that moves in line with interest rates

HY FRNs are bonds that form a small, but growing subset of the global HY bond universe, with an estimated total market capitalisation of around $60bn at the start of 2022[1].

Their most notable feature, which differentiates them from traditional HY bonds, is that they offer floating rate coupons that move in line with interest rates. If interest rates rise, a HY FRN investor will receive correspondingly higher income, whereas an investor in a traditional HY bond receives the same fixed coupon amount until that bond matures. The relative attractiveness of coupons from an existing fixed rate HY bond will therefore reduce when market interest rates rise, as higher levels of income can be found elsewhere.

HY FRN coupons are linked to standard reference rates, or 'cash rates', which are typically three-month EURIBOR, SONIA (Sterling Overnight Index Average) or SOFR (Secured Overnight Financing Rate) for debt issued in euros, pound sterling and US dollars respectively. These interest rates generally represent the rates at which banks borrow money from each other. High yield floating rate bonds also typically feature 'interest rate floors', which means that the reference rate is ascribed a minimum value of 0% in the income calculation, even if the market interest rate is below zero. This can provide income protection when interest rates are negative.

The amount paid to investors through HY FRN coupons typically resets quarterly, which means these bonds are expected to have 0.00-0.25 years of duration. A measure of how sensitive bond prices are to changes in interest rates, duration is expressed in years and calculated as a relationship between a bond's price, its coupon and the interest rate in the market. As such, when interest rates rise, all other factors being equal, HY FRNs would be expected to incur minimal capital losses. Conversely, the price of a bond with fixed rate coupons would be expected to fall when interest rates rise. Bond prices move inversely to interest rates.

At the start of 2022, the duration of the global HY bond universe, as represented by the *ICE BofA Global High Yield Index,* was around 4.0 years. Meanwhile, investment grade corporate bonds, as measured by the Bloomberg Global Investment Grade Corporate Bond Index, had approximately 7 years of duration. A rise in interest rates of 1.0 percentage points would therefore lead to approximate capital losses of 4% and 7% respectively[2].

[1] *As at 1 Jan 2022. Source: Bloomberg, M&G analysis.*

[2] *As at 1 Jan 2022. Source: Bloomberg*

Higher potential yields to protect against inflation

Both HY FRNs and traditional HY bonds can be expected to pay higher coupons than investment grade corporate and government bonds, which means that they stand a better chance of generating income that can keep pace with inflation. This is because HY debt is issued by companies rated as non-investment grade (below BBB-) by credit rating agencies. As such, investors demand higher compensation for managing the additional risks that investing in these companies may present.

The higher coupons offered by HY FRNs also means that the majority of anticipated total returns from these bonds over the medium-to-long term may be expected to be driven by income, rather than capital gains, due to the effects of compound interest at these higher rates.

Defensive characteristics

HY FRNs offer several protective features that seek to mitigate risks for investors. Firstly, around 80% of the HY FRN market is ranked as senior-secured in the issuing companies' capital structures, compared to around 20% of the broader HY bond universe[3].

Senior debt ranks higher than junior debt and company shares, which means holders of these securities are first in line to recover some or all of their capital in the case of a potential default. Senior-secured status provides additional protections by ringfencing specific, predetermined company assets should a default occur. This further increases the chances of recovery for bondholders, with senior-secured debt having historically provided higher recovery rates than unsecured debt. For this reason, when we analyse bonds for potential inclusion in our HY FRN portfolios, we typically prefer companies with physical assets that can be secured.

HY FRNs also typically have lower volatility than traditional HY bonds. Spread duration measures how sensitive a bond's price is to changes in credit spreads (which measure the difference between government and corporate bonds' yields, and therefore widen when investors believe the risk of holding corporate bonds increases and narrow when they believe it decreases). The HY FRN market's spread duration is around 2.0 years compared to approximately 4.0 years for the global HY bond market[4]. A 1.0 percentage points rise in credit spreads would therefore lead to capital losses of around 2% for HY FRNs and 4% for fixed rate HY bonds.

As a result, HY FRNs will normally follow the same overall direction as the fixed rate HY market when investors perceive credit risks to be higher, but with lower fluctuations in price. This has been the case during various periods of uncertainty over the past decade, including around expected US tapering in 2015, global inflation fears in 2018 and the recent COVID-19 crisis.

A HY FRN portfolio manager must assess the defensive features of any bond in the context of the fundamental outlook for both the economy and the individual company. We believe active management provides the potential to further reduce investment risks by avoiding bonds that present excessive risks and capturing more appealing opportunities.

Liquidity

HY FRNs are liquid securities, with trades settling in two days (T+2) in normal market conditions. Our HY FRN strategy offers daily dealing, which has been possible even in stressed market conditions, such as during the global outbreak of COVID-19 in March 2020.

This is one of the key potential benefits of HY FRNs compared to other types of floating rate high yield debt, notably leveraged loans, which share some characteristics with HY FRNs but can be difficult to access for non-institutional investors, given their longer settlement times and the difficulty of buying and selling in volatile markets.

Our approach to HY FRNs

At M&G, we have managed our HY FRN strategies since 2014, with our analysts covering 97% of the global market thanks to the extensive resources and capabilities of our in-house credit research team, which is one of the largest among European asset managers.

In managing the strategies, we seek to capture the potential opportunities presented by the asset class, while reducing credit risks relative to the broader market index.

We typically have lower exposure to cyclical sectors such as energy and retail, which follow the economy closely and therefore can be more volatile than other industries, compared to the index. In the current environment, we have sought higher exposure to financial sector companies, which normally fare better when interest rates rise due to the increased profit margins they can make when lending money.

We also seek to increase diversification by investing in potential opportunities that are not captured by the index – for instance, if the size of the bond issuance does not

[3] Source: M&G, Moody's Research; ICE BofA Global Floating Rate High Yield 3% Constrained Index, ICE BofA Global High Yield Index; 31 December 2020.

[4] Source: Bloomberg, 1 November 2021.

meet the minimum amount required for inclusion. In our view, this minimum inclusion size makes the index more exposed to risks from larger individual borrowers and does not capture the full potential opportunity set available from the asset class.

We believe HY FRNs are well-suited to the current investment environment, thanks to their potential to protect investors against expected interest rate rises and inflation. At the same time, the outlook for defaults remains stable, in our view, with many companies reporting higher earnings and therefore a better ability to service their debts, helping to protect against potential downside risks for high yield bond issuers. As ever, we will look to manage these risks using our extensive resources and capabilities, with a view to providing stable, long-term returns for our investors.

Investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the fund.

High yield bonds usually carry greater risk that the bond issuers may not be able to pay interest or return the capital.

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