

# Staying afloat: Embrace the rising rates era with floating rate bonds



M&G Fixed Income team  
March 2022

- High yield floating rate bonds, also known as high yield floating rate notes, are a growing subset of the global high yield bond universe.
- Their main potential advantage over traditional high yield bonds is their floating rate coupons, which seek to generate income that rises in line with interest rates and potentially reduces the risk of capital loss in rising rate environments through lower interest rate sensitivity (duration).
- High yield floating rate bonds may also offer more defensive characteristics than traditional high yield bonds, with lower market volatility and a higher proportion of bonds ranked as senior-secured in the capital structure. In managing our high yield floating rate bond strategy, we seek to further reduce potential risks and increase diversification relative to the benchmark index.
- As with regular high yield bonds, high yield floating rate bonds seek to generate higher potential income than their investment grade counterparts, which can help to protect against inflation eroding the real value of future cashflows.
- High yield floating rate bonds are generally liquid securities and daily dealing can be maintained, even in stressed market conditions.
- The value of the fund's assets will go down as well as up. This will cause the value of your investment to fall as well.
- ***For further information on floating rate bonds, please take a look at our short video from fund manager James Tomlins, a Chinese subtitled version available on [this website](#).***

## Income that moves in line with interest rates

High yield floating rate bonds are an increasingly large subset of the global high yield bond universe.

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

High yield floating rate bond coupons are linked to standard reference rates, or 'cash rates', which are typically 3-month EURIBOR, SONIA (Sterling Overnight Index Average) or SOFR (Secured Overnight Financing Rate) for debt issued in euro, pound sterling and US dollar respectively. These bonds 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 high yield floating rate coupons typically resets quarterly. In other words, these bonds are expected to have between 0 and 0.25 years of duration – a measure of how sensitive bond prices are to changes in interest rates. As such, when interest rates rise, all other factors being equal, high yield floating rate bonds would be expected to not only pay higher levels of income, but also incur minimal capital losses. Conversely, the price of a bond with fixed rate coupons would be expected to fall when interest rates rise.

At the start of 2022, the duration of the global high yield bond universe, as represented by the *ICE BofA Global High Yield Index*, was around four years. Meanwhile, investment grade corporate bonds, as measured by the Bloomberg Global Investment Grade Corporate Bond Index, had approximately seven years of duration. A

rise in interest rates of 1% would therefore lead to approximate capital losses of 4% and 7% respectively<sup>1</sup>.

## Higher potential yields to protect against inflation

Both high yield floating rate bonds and traditional high yield bonds can be expected to pay higher coupons than investment grade corporate and government bonds, and therefore stand a better chance of generating income that can keep pace with inflation. This is because high yield 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.

Another consequence of the higher coupons offered by high yield floating rate bonds is 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.

## Lower volatility, senior and secured in capital structure

High yield floating rate bonds offer several protective features that seek to mitigate risks for investors. Firstly, around 80% of the high yield floating rate bond market is ranked as senior-secured in the issuing companies' capital structures, compared to around 20% of the broader high yield bond universe<sup>2</sup>.

Senior debt ranks higher than junior debt and equity, so 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 high yield floating rate bond portfolios, we typically prefer companies with physical assets that can be secured.

In addition, high yield floating rate bonds typically have lower volatility than traditional high yield bonds. The high yield floating rate bond market's spread duration, which measures how sensitive a bond's price is to changes in credit spreads, was around two years compared to approximately four years for the global high yield bond market at the start of 2022. A 1pp rise

in credit spreads would therefore lead to capital losses of around 2% for high yield floating rate bonds and 4% for fixed rate high yield bonds<sup>3</sup>.

As a result, high yield floating rate bonds will normally follow the same overall direction as the fixed rate high yield 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.

## Bond liquidity, leveraged loans features

High yield floating rate bonds are liquid securities, with trades settling in two days (T+2) in normal market conditions. Our high yield floating rate bond 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 high yield floating rate bonds compared to other types of floating rate high yield debt, notably leveraged loans, which share some characteristics with high yield floating rate bonds but can be difficult to access for non-institutional investors, due to their longer settlement times and the difficulty of buying and selling in volatile markets. For example, settlement times for leveraged loans are usually T+7 or T+10, and sometimes even much longer.

## Synthetic high yield floating rate bonds for increased flexibility

A portfolio's liquidity and potential opportunity set can be enhanced by creating high yield floating rate bonds synthetically. We look to achieve this in two ways: firstly, we may purchase a fixed rate high yield bond and effectively remove duration using interest rate swaps. This significantly increases the strategy's investable universe, given the breadth and depth of the global high yield bond market.

Alternatively, we may seek to increase our credit exposure via high yield credit default swaps, which allow us to access the high yield market's credit risk premium with better liquidity than through physical bonds. All the instruments that can be used to create synthetic high yield floating rate bonds are typically more liquid than the pure high yield floating rate bond.

<sup>1</sup> Source: ICE BofA index and Bloomberg index, 31 Jan 2022

<sup>2</sup> Source: ICE BofA index, 31 Jan 2022

<sup>3</sup>

Floating Rate High Yield 3% Constrained Index, ICE BofA Global High Yield Index; 31 December 2020

## Our unique approach to manage a high yield floating rate portfolio

At M&G, we have managed our high yield floating rate strategy 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 strategy, we seek to capture the potential opportunities presented by the asset class, while reducing credit risks relative to the broader market index.

In addition, our ability to create synthetic floating rate bonds using CDS instruments and interest rate swaps can provide us with greater flexibility for portfolio management and can provide upside potential.

In our view, high yield floating rate bonds 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, 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.

The views expressed in this document should not be taken as a recommendation, advice or forecast.

**M&G Fixed Income team**  
**March 2022**

**For Investment Professionals, Institutional Investors, Accredited Investors and Professional Investors only. Not for onward distribution. No other persons should rely on any information contained within.**

In Hong Kong, this financial promotion is issued by M&G Investments (Hong Kong) Limited. Office: Unit 1002, LHT Tower, 31 Queen's Road Central, Hong Kong; in Singapore by M&G Investments (Singapore) Pte. Ltd. (Co. Reg. No. 201131425R), regulated by the Monetary Authority of Singapore; and in Taiwan by M&G International Investments S.A. Registered Office: 16, boulevard Royal, L-2449, Luxembourg.

For Hong Kong only: The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer of any funds mentioned in it. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice. Shares, units or other interests in the funds mentioned in this document may only be offered or sold in Hong Kong to persons who are "professional investors" as defined in the Securities and Futures Ordinance ("Ordinance") and any rules made under the Ordinance – or in circumstances which are permitted under the Companies (Winding Up and Miscellaneous Provisions) Ordinance. In addition, distribution of this document in Hong Kong is restricted. It may not be issued or possessed for the purposes of issue, whether in Hong Kong or elsewhere, and shares, units or other interests in the funds mentioned may not be disposed of to any person unless such person is a "professional investor" as defined in the Ordinance and any rules made under the Ordinance or as otherwise may be permitted under Hong Kong law.

For Singapore only: For "accredited investors" and "institutional investors" as defined under the Securities and Futures Act (Cap. 289) of Singapore ("SFA") only. This document forms part of, and should be read in conjunction with, the Information Memorandum of the Fund and other communications permitted for offers made in reliance of prospectus exemptions under the SFA. All forms of investments carry risks. Such investments may not be suitable for everyone.

For Taiwan only: The financial product(s) offered herein has not been reviewed or approved by the competent authorities and is not subject to any filing or reporting requirement. The financial product(s) offered herein is only permitted to be recommended or introduced to or purchased by customers of an offshore banking unit of a bank ("OBU")/offshore securities unit of a securities firm ("OSU") which customers reside outside the R.O.C. Customers of an OBU/OSU are not eligible to use the financial consumer dispute resolution mechanism under the Financial Consumer Protection Law. This product(s) may be made available for purchase by Taiwan OBUs/OSUs acting on behalf of non-Taiwan customers of such units but may not otherwise be offered or sold in Taiwan.

M&G Investments (Hong Kong) Limited, M&G International Investments S.A., M&G Investments (Singapore) Pte. Ltd and the funds referred to in this document may not be authorised, recognised or regulated by the local regulator in your jurisdiction. This information is not an offer or solicitation of an offer for the purchase or sale of investment shares in one of the funds referred to herein.