Potential opportunities in high yield floating rate bonds

M&G (Lux) Global Floating Rate High Yield Fund

M&G Wholesale Public Fixed Income team

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- Low duration, high income strategies can offer potential protection in today's low yield, inflationary environment.
- High yield floating rate notes (also known as floating rate bonds, or 'HY FRNs') currently provide a potential opportunity versus conventional HY bonds, due to their minimal interest rate risk and lower intrinsic volatility.
- The M&G (Lux) Global Floating Rate High Yield Fund is designed to provide a defensive and liquid approach to HY investing.

The value and income from the 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.

Investors seek lower duration and higher potential income

Having lagged investment grade (IG) credit returns during the market turbulence of 2020, HY corporate bonds have recovered strongly since, as investors seek to reduce their duration (interest rate sensitivity) risks and increase income potential within their portfolios.

The benign default outlook for many sectors, combined with improving HY company fundamentals and expectations that central banks will continue tightening monetary policy, means that HY bonds could offer a potentially attractive way for investors to protect their portfolios from rising interest rate and inflation risks.

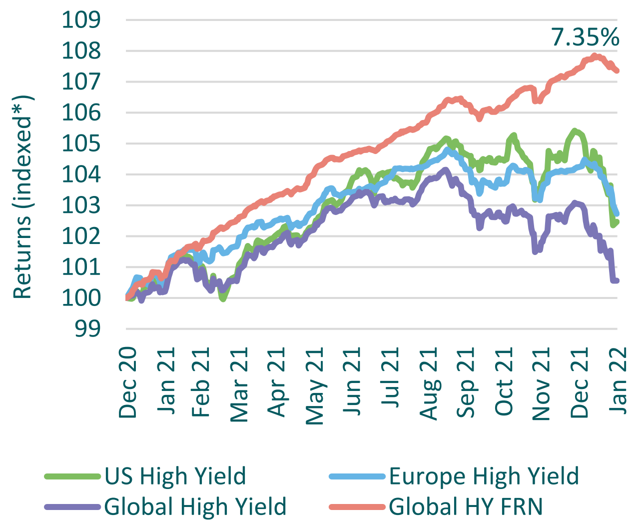
In particular, HY FRNs could play an important role in portfolio diversification, with the asset class having materially outperformed other areas of HY bond markets since the end of 2020, as shown in Figure 1, delivering a 7.35% cumulative return.

In this short note, we explore what we believe are the main drivers behind the potential opportunity in HY FRNs and offer an insight into how we aim to navigate the coming period in managing the M&G (Lux) Global Floating Rate High Yield Fund.

Please remember that 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.

Figure 1. HY FRNs outperform fixed HY as policy tightens

Past performance is not a guide to future performance.



**Returns rebased to 100 as at 31 December 2020.*

Source: ICE Bank of America Indices, 31 January 2022. Information is subject to change and is not a guarantee of future results.

Global HY: ICE BoA Global High Yield Index. Global HY FRN: ICE BofA Global High Yield Floating Rate Loan (3% Constrained) Index. US HY: ICE BoA US High Yield Index. Europe HY: ICE BoA European High Yield Index.

1. Lower interest rate risk

The US Federal Reserve began tapering its asset purchases at the end of last year, and many analysts forecast that we will see several US interest rate rises in 2022. Across the Atlantic, the Bank of England raised rates twice in the space of two months to 0.5% in early

February, and while the European Central Bank appears more reluctant to tighten monetary policy than its US and UK counterparts, some observers believe its hand may also be forced by the end of the year.

If future interest rate rises materialise, the potential increase in sovereign bond yields is likely to have a negative effect on the value of other fixed rate bonds. While HY corporate bonds typically have lower interest rate sensitivity (duration) than their IG credit and sovereign counterparts, the average duration of the *ICE BofA Global High Yield Index* is still significant, at 4.15 years[1]. This would likely result in a higher potential impact on capital compared to HY FRNs, which typically have close to zero duration due to their floating coupons, which rise in line with interest rates.

2. Historically lower volatility during market stress

The HY FRN market beta (a measurement of market risk or volatility) is lower than for conventional HY bonds, with an average spread duration of 1.9 years compared to 4.1 years[2]. (Spread duration indicates the sensitivity of a bond's price to changes in its credit spread.) As a result, HY FRNs will typically follow the same overall direction as the fixed rate HY market, but with lower volatility, particularly in times of market stress. This has been the case during various market episodes over the past decade, where HY FRNs have experienced a lower drawdown than the conventional HY bond market, including in periods of uncertainty around potential US tapering in 2015, the global inflation scare in 2018 and the recent COVID-19 crisis.

3. Technical factors support HY FRN demand

Collateralised loan obligations (CLOs), which are securities backed by a pool of loans and similar debt, are a significant buyer of HY FRNs. The ongoing surge in mergers and acquisitions (M&A) means that CLOs may continue to drive strong technical demand for HY FRNs in the coming period. Although CLO issuance dried up in 2020, which proved a headwind for HY FRNs, market supply hit record highs in 2021 and is forecast to continue in 2022, driven by strong M&A activity[3].

M&G (Lux) Global Floating Rate High Yield Fund

We originally launched our global HY FRN strategy in 2014, and today investors can access this through the M&G (Lux) Global Floating Rate High Yield Fund. In managing the fund, we look to apply a more defensive approach to investing in the asset class compared to the benchmark index, with historically lower concentrations in certain cyclical sectors with a view to reducing volatility. We have also looked to avoid some distressed index constituents in recent periods.

In this context, the fund has delivered positive long-term returns, with particularly robust performance over the past year (see performance tables below). Today, our focus remains on providing capital protection, minimal interest rate risk and daily liquidity. A large majority of the portfolio is invested in senior-secured bonds, which can provide significant downside protection through higher potential recovery rates in default scenarios as they are top of a company's capital structure, ahead of other types of debt and of equity. The fund also offers daily dealing, which is not typically available for less liquid HY alternatives, such as leveraged loan funds. Currently, over 80%[4] of the portfolio is invested in physical HY FRNs – as opposed to synthetic floating rate positions – due to the relative value opportunity we believe currently exists in the asset class.

We believe global HY FRNs represent an attractive potential opportunity for portfolio diversification, given the broader macro environment and our extensive capabilities in this area, with M&G being among the leading active bond investors in Europe, with its $243 billion of fixed income funds under management[5] and one of the region's largest in-house credit research teams. In our view, the M&G (Lux) Global Floating Rate High Yield Fund remains well-positioned to capitalise on these potential opportunities for investors.

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[1] *Source: ICE BofA index, 31 Jan 2022*
[2] *Source: ICE BoA Global High Yield Index, ICE BofA Global High Yield Floating Rate Loan (3% Constrained) Index, 10 Feb 2022*
[3] *Source: Deutsche Bank Research, European Securitisation Outlook 2022, 15 Dec 2021*
[4] *Source: M&G, 31 Jan 2022*
[5] *Source: M&G, 30 Jun 2021*

Fund performance

Past performance is not a guide to future performance.

Since inception, annualised

Return (%)	YTD	YTQ	1 Yr pa	2 Yrs pa	3 Yrs pa	4 Yrs pa	5 Yrs pa	10 Yrs PA
Fund (EUR A-H)	**-0.38**	**4.46**	**3.70**	**1.56**	**2.04**	**1.16**	**1.15**	**N/A**
Benchmark (EUR)	**-0.12**	**6.55**	**5.73**	**4.00**	**4.63**	**3.34**	**3.06**	**N/A**

Calendar years

Return (%)	2015	2016	2017	2018	2019	2020	2021
Fund (EUR A-H)	**-0.43**	**6.51**	**1.62**	**-2.57**	**4.25**	**-0.75**	**4.46**
Benchmark (EUR)	**-0.69**	**11.13**	**2.73**	**-1.30**	**6.84**	**1.99**	**6.55**

YTQ = year to most recent quarter

*Share class inception date: 11 September 2014.This is the inception date of the UK-authorised OEIC. Fund performance prior to 21 September 2018 is that of the equivalent UK-authorised OEIC, which merged into this fund on 7 December 2018. Tax rates and charges may differ. As the OEIC launched in 2014, we are unable to show 10 years' worth of fund performance.

**Benchmark prior to 01 April 2016 is the ICE BofAML Global Floating Rate High Yield (Hedged) Index. Thereafter it is the ICE BofAML Global Floating Rate High Yield 3% Constrained (Hedged) Index.

The benchmark is a comparator against which the fund's performance can be measured. The index has been chosen as the fund's benchmark as it best reflects the scope of the fund's investment policy. The benchmark is used solely to measure the fund's performance and does not constrain the fund's portfolio construction. The fund is actively managed. The investment manager has complete freedom in choosing which investments to buy, hold and sell in the fund. The fund's holdings may deviate significantly from the benchmark's constituents.

Source: Source: Morningstar, Inc., as at 31 January 2022, EUR Class A-Hedged Acc shares, price-to-price, income reinvested.

The fund allows for the extensive use of derivatives.

Investing in this fund means acquiring units or shares in a fund, and not in a given underlying asset such as a building or shares of a company, as these are only the underlying assets owned by the fund.

Further risks associated with the fund can be found in the fund's Key Investor Information Document

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UCITS HAVE NO GUARANTEED RETURN, AND PAST PERFORMANCE IS NOT A GUIDE TO FUTURE PERFORMANCE

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