

High yield floating rate note (HY FRN) outlook

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

M&G Public Fixed Income team

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- High yield floating rate notes (HY FRNs) have significantly outperformed fixed rate bonds during the monetary policy tightening cycle, thanks in no small part to their low duration risks.
- We believe the investment environment remains favourable to the asset class, given expected future interest rate rises are yet to feed into HY FRN coupons.
- The first half of 2022 ended with a major sell-off in credit spreads due to more persistent inflation than anticipated and increased fears of recessionary outcomes. We believe this presents some attractive potential opportunities, particularly given the additional security of senior-secured debt.

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. Past performance is not a guide to future performance.

HY FRNs continue to outperform

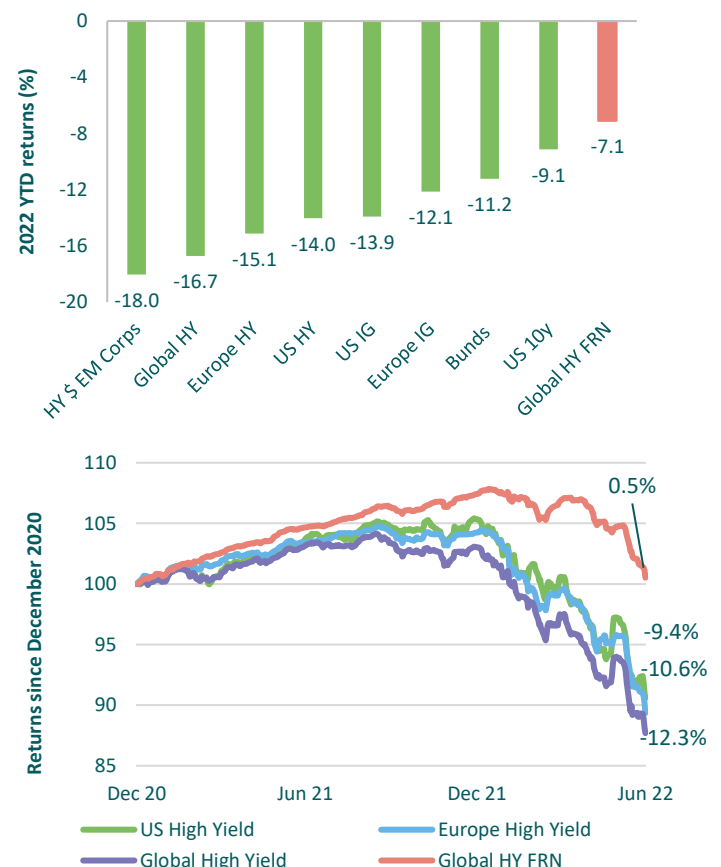
The year so far has been brutal for many fixed income assets. The sell-off has come in two phases: the first driven by duration risks and persistent inflation, and the second, more recently, by increased fears of recessionary outcomes and consequent risk aversion, notably in June.

Floating rate bonds have held up better than their fixed rate counterparts, thanks in no small part to their variable coupons, which move in line with cash reference rates. As Figure 1 shows, HY FRNs have posted negative year-to-date (to end June) returns due to credit spreads (the difference between corporate bond yields and government bond yields) widening. However, their lack of duration risk (sensitivity to changes in interest rates) has resulted in significant overall outperformance against both investment grade and high yield alternatives.

This outperformance is even more pronounced when measured from the end of 2020, by which time markets had begun to price in tighter future monetary policy, essentially a rise in interest rates. Over this period, HY FRNs have delivered a flat total return, while fixed rate high yield bonds have posted double-digit negative returns in the same period, as shown in Figure 2.

We believe the current environment presents a strong case for HY FRNs, with interest rates and consumer prices expected to rise substantially further. In particular, we believe HY FRNs possess three characteristics, which – in our view – mean the asset class should continue to offer potentially attractive diversification properties for fixed income investors in the period ahead.

Figures 1&2. Fixed income asset returns over 6m & 18m



Past performance is not a guide to future performance.

Source: ICE Bank of America Indices, 30 June 2022. Index performance shown hedged in USD. 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.

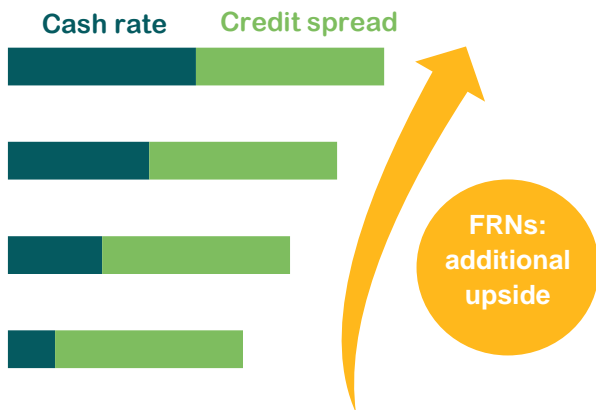
1. Low duration

HY FRNs have close to no duration, which means that all other things remaining equal, interest rate rises should not result in any capital losses for bondholders. This makes HY FRNs potentially more attractive than the broader global high yield bond market for investors who may be worried that future central bank rate rises could lead to further sell-offs in fixed rate assets.

2. Floating rate income

HY FRN coupons typically reset in line with cash interest rates every three months. Given central banks, notably the European Central Bank, are still in the early stages of their interest rate hiking cycles, this means that future rate rises have still not yet fed into HY FRN coupons. Higher expected interest rates are therefore likely to benefit HY FRN investors by offering elevated income potential, as illustrated in Figure 3.

Figure 3. HY FRN coupons should increase as central banks continue to raise cash interest rates



Source: M&G. For illustrative purposes only.

Elevated credit spreads

In 2022, we have seen a significant revaluation in credit spreads. High yield spreads are now discounting a significant economic slowdown and, in our view, excessive defaults relative to the strength of company balance sheets heading into the current phase relative to historical recessions. HY FRNs are also typically senior-

secured in the capital structure, which provides additional levels of downside protection.

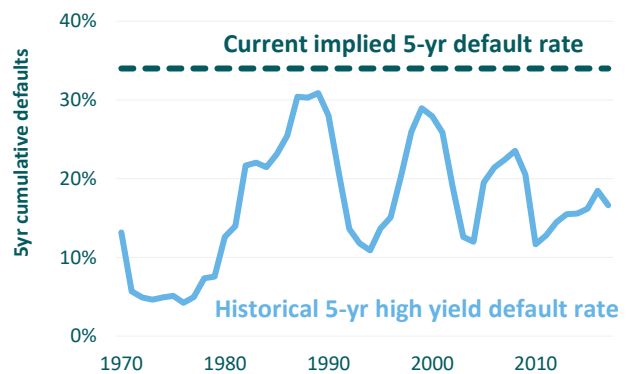
As active managers, we look to further mitigate default risks through bottom-up credit analysis, with our portfolio currently positioned more defensively than the benchmark index. We are focusing on less inflation-sensitive sectors and companies, such as food retailers, software companies and education providers. We believe valuations in these areas look attractive and should benefit once the market stabilises.

Outlook

We believe companies have entered this economic slowdown in healthy positions, with net leverage and interest coverage having been strong in recent periods. This indicates that a future recession could be relatively shallow. As such, we anticipate defaults will likely be lower than in previous recessions, with default rates in the range of 3-4%, in our view, rather than the 10-15% seen in some historical scenarios.

The positive news is that credit spreads are already compensating investors for such an environment. At current levels, markets are pricing in a full-blown recession with defaults of 30-40% within the high yield universe, as shown in Figure 4. We therefore believe that HY FRNs offer potentially attractive compensation relative to credit risks, particularly given their seniority in the capital structure.

Figure 4. HY FRN coupons should increase as central banks continue to raise cash interest rates



Past performance is not a guide to future performance.

Source: Deutsche bank, ICE Bank of America, Moody's Research, 14 June 2022 (latest data available). Calculated using the CDX HY index with 30% recovery rate assumption.

As shown in Figure 5, our portfolio remains positioned to cope with a range of potential scenarios, should interest rates and spreads change. If the market stabilises while interest rates rise, as our base-case highlighted in blue below shows, this would be expected to result in high single-digit to double-digit returns from the asset class.

Figure 5. Potential return scenarios for changing credit spreads and interest rates, USD unhedged (base-case highlighted in blue)

		Change in credit spreads (%)								
		-2.0	-1.5	-1.0	-0.5	0.0	0.5	1.0	1.5	2.0
Change in interest rates (%)	-1.0	15.4	13.7	11.9	10.2	8.4	6.6	4.9	3.1	1.4
	-0.5	15.5	13.8	12.0	10.3	8.5	6.7	5.0	3.2	1.5
	0.0	15.6	13.9	12.1	10.4	8.6	6.8	5.1	3.3	1.6
	0.5	16.1	14.4	12.6	10.9	9.1	7.3	5.6	3.8	2.1
	1.0	16.6	14.9	13.1	11.4	9.6	7.8	6.1	4.3	2.6

Source: M&G (Lux) Global Floating Rate High Yield Fund, ICE BoA, 30 June 2022. Assumed 1% default rate with an average recovery of 60% for the floating high yield market and 30% for the global fixed high yield market. It is assumed 70% of the fund's positions have a 0% SOFR floor. A parallel shift in the yield curve is assumed. This is for illustrative purposes only and based on representative assumptions. This is not a projection or guarantee of future results.

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

Return (%)	YTD to latest quarter	YTD	1 Yr pa	3 Yrs pa	5 Yrs pa	10 Yrs PA
Fund A-H EUR Acc	-7.77	-7.77	-6.79	-1.14	-0.61	N/A
Benchmark*	-7.13	-7.13	-5.09	1.09	1.42	N/A

Return (%)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Fund A-H EUR Acc	N/A	N/A	N/A	-0.43	6.51	1.62	-2.57	4.25	-0.75	4.46
Benchmark*	N/A	N/A	2.12	-0.69	11.13	2.73	-1.30	6.84	1.99	6.55

Past performance is not a guide to future performance.

*Benchmark = : BofA Merrill Lynch Global Floating Rate High Yield Index (3% constrained) USD Hedged Index. Benchmark prior to 01 April 2016 is the ICE BofAML Global Floating Rate High Yield (EUR Hedged) Index. Thereafter it is the ICE BofAML Global Floating Rate High Yield 3% Constrained (EUR 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.

Fund performance prior to 21 September 2018 is that of the EUR Class A-H Accumulation of the M&G Global Floating Rate High Yield Fund (a UK-authorized OEIC), which merged into this fund on 7 December 2018. Tax rates and charges may differ.

Source: Morningstar, Inc and M&G, as at 30 June 2022. Returns are calculated on a price to price basis with income reinvested. Benchmark returns stated in EUR terms.

Fund description

The fund aims to provide a combination of capital growth and income to deliver a return that is higher than that of the global floating rate high yield bond market (as measured by the BofA Merrill Lynch Global Floating Rate High Yield Index (3% constrained) USD Hedged) over any five-year period. At least 70% of the fund is invested in high yield floating rate notes (FRNs), focusing on FRNs issued by companies with a low credit rating, which typically pay higher levels of interest to compensate investors for the greater risk of default. Part of the fund may be invested in other fixed income assets, such as government bonds. Asset exposure is gained through physical holdings and the use of derivatives.

Key fund risks

- 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 fund may use derivatives to profit from an expected rise or fall in the value of an asset. Should the asset's value vary in an unexpected way, the fund will incur a loss. The fund's use of derivatives may be extensive and exceed the value of its assets (leverage). This has the effect of magnifying the size of losses and gains, resulting in greater fluctuations in the value of the fund.
- Investing in emerging markets involves a greater risk of loss due to greater political, tax, economic, foreign exchange, liquidity and regulatory risks, among other factors. There may be difficulties in buying, selling, safekeeping or valuing investments in such countries.
- The fund is exposed to different currencies. Derivatives are used to minimise, but may not always eliminate, the impact of movements in currency exchange rates.
- The hedging process seeks to minimise, but cannot eliminate, the effect of movements in exchange rates on the performance of the hedged share class. Hedging also limits the ability to gain from favourable movements in exchange rates.

Further details of the risks that apply to the fund can be found in the fund's Prospectus.

Other important information

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.

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



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