M&G Short Dated Corporate Bond Fund

Seeking opportunities at the front-end of the yield curve

Matthew Russell, fund manager

April 2023

- We believe short-dated corporate bonds proved their worth in 2022, showing resilience versus other bond assets and limiting the losses caused by higher bond yields (ie increases in interest rates) on fixed income portfolios
- We argue accessing a short-dated corporate bonds solution could be an attractive option for those investors concerned about interest rate rises and volatility in 2023-24
- The M&G Short Dated Corporate Bond Fund is structurally defensive with a low duration (a lower interest rate risk sensitivity) range of 0-3 years; currently the portfolio's duration is 1.6/1.7 years
- The fund holds nearly 60% in very short dated (0-3 years) corporate bond assets - increasing to almost 90% when we include similar bonds maturing 3-5 years
- Our global team of credit analysts continue to focus on perceived value within financial sector bonds issued by so-called 'national champions' – and this still holds despite recent sector uncertainty

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 and you may get back less than you originally invested. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested.

Defensive at the right time

Most investors view bonds as the low risk portion of their overall portfolio but, as many have found in last 12 months or so, not all bonds are created equal. Higher government bond yields (ie rising interest rates), over which corporate bonds are priced, resulted in some heavy losses for bond investors in 2022. As a general rule of thumb the longer a bond has until it matures, the more capital value it will lose if interest rates rise (and the more it will gain if they fall). In the UK, the investment grade corporate bond index lost 20% in 2022. By comparison, the short-dated index (bonds with 1-3 years until maturity) lost about 5%. Not ideal, but we believe there are few bond assets out there that would have done a better job at limiting the losses that higher yields have brought to financial markets recently.

The M&G Short Dated Corporate Bond Fund utilises a clear, defensive short-dated proposition, with a low duration range of 0-3 years designed to protect against higher interest rates. As at February 28 2023, portfolio duration was around 1.7 years, with rates risk derived from UK sterling (0.9) assets, Euro assets (0.4) with US dollar assets accounting for 0.3 years. The equivalent period last year duration was around 1.4 years and derived from UK sterling (0.8) assets, Euro assets (0.3 years), with 0.2 years of US dollar assets. So duration has crept up slightly as bond yields have risen across the board in 12 months, but we still think it is suitably defensive given ongoing rates uncertainty.

Active management in short-dated credit

Having a clear, defensive proposition to attempt to limit losses to capital value during a rate-rising environment is one thing, but what can be done to try and improve the risk-reward profile of a short-dated credit strategy during volatile periods? Within our fund, there are three key ways we try to add value:

Global credit

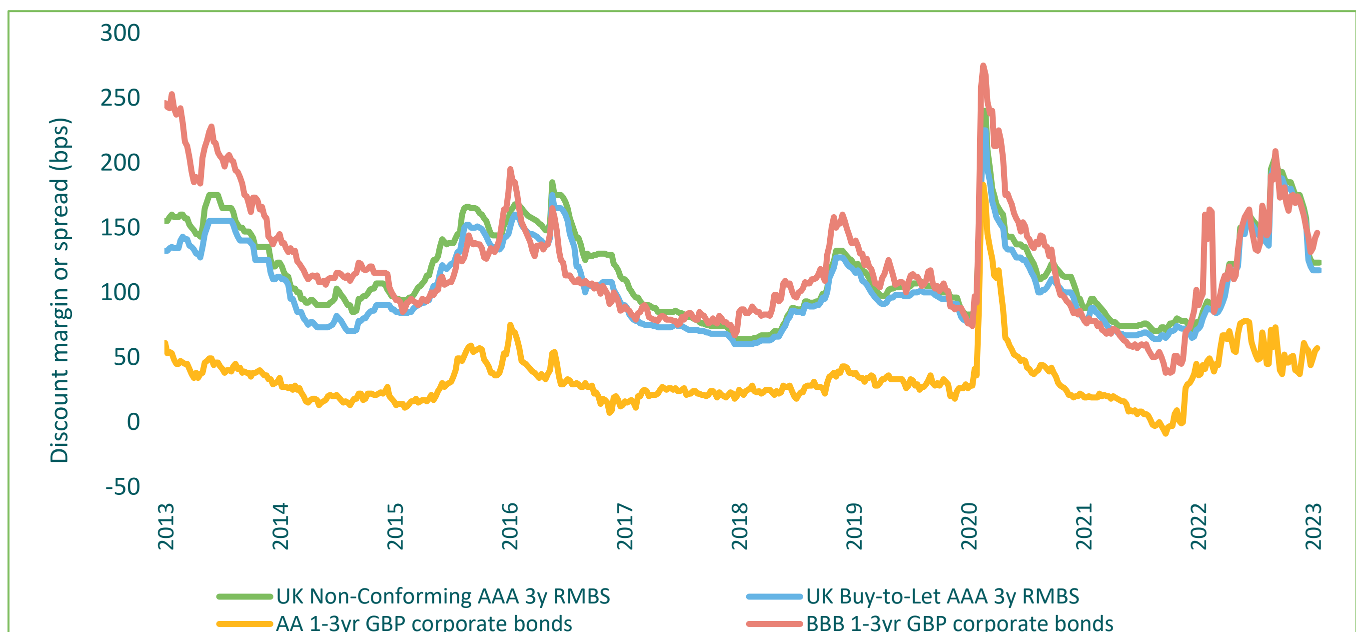
One area where we believe we can try to add value is being active within the global corporate bonds market – and in the process drawing on the expertise of M&G's in-house credit research team as we seek to identify the most compelling opportunities across global credit markets. In a more volatile market environment, with increasing dispersion between individual credit valuations, we believe the current backdrop can provide a rich source of alpha-generating opportunities for active managers such as ourselves.

As at 28 February 2023, the fund's credit spread duration (portfolio sensitivity to corporate bond risk) was around 3.0 years with credit risk mainly derived from UK sterling (1.3 years), Euro credit (1.1 years) and some US dollar issues (around 0.6 years' worth). The equivalent period last year, credit spread duration was around 3.1 years and split between Euro (1.0) and UK sterling (1.5) assets, with 0.6 years of US dollar assets. We believe this level of credit risk is cautious enough given market volatility, but contains sufficient corporate bond exposure (which we can adjust) based on current valuations and the overall outlook for the global economy.

ABS research premium

We consider M&G as something of a leader in investing in UK and European asset-backed securities (ABS), in which the fund can invest. The relative complexity of researching ABS is a key reason, in our view, why this asset class offers investors a risk premium in excess of regular corporate bonds. Investing in AAA rated ABS (in the below example, residential mortgage-backed securities) has offered a similar level of credit spread to investors as short-dated BBB rated corporate bonds - and higher than short-dated AA rated corporate bonds. (see Figure 1, below)

Figure 1. ABS complexity premium. AAA-rated ABS offer a similar risk premium to BBB corporates



RMBS = residential mortgage-backed securities

Source: JP Morgan, Bloomberg, 28 February 2023

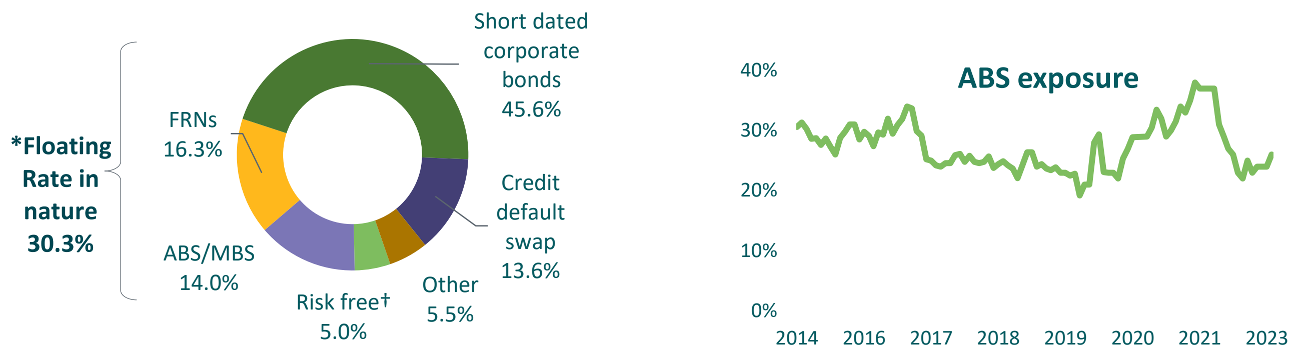
Floating rate notes

The fund also has the flexibility to invest in floating rate notes – debt instruments with coupons that fluctuate with interest rates. Because coupons are made of a variable component plus a fixed spread, we suggest they can help protect investors from rising rates and add upside potential. Currently around a third of fund assets are floating rate (see Figure 2). These are invested mainly in floating rate notes, but also across subsectors called asset-backed securities and mortgage-backed securities (not all ABS are floating rate in nature, however).

Within ABS, we use as much as possible the full resource of the global credit research team throughout what can be a complex process. For the most part, fund holdings of ABS – a combination of traditional ABS and also residential mortgage-backed securities - have remained above 20%. Today it's c26% and mainly in what we call 'national champions' like blue-chip banks and finance companies with robust balance sheets. Regionally, the UK

dominates issuance (c19%), while in terms of ratings quality, the biggest part of ABS paper held is AAA rated. The average rating of the fund is A-.

Figure 2. Asset allocation, % fund (left) and historic exposure to asset backed securities (right)



*not all ABS is floating rate in nature † includes cash, government bonds and credit default swap contracts. MBS = Mortgage backed securities. Please note, portfolio data is based on internal sources, is unaudited and may differ from information as shown in the Monthly Fund Review.

Source: M&G Investments, 28 February 2023.

Portfolio positioning

We continue to run a defensive duration position (c1.6 years) as rates uncertainty persists. Meanwhile, we believe there are pockets of value in investment grade credit spreads, which in our view overcompensate investors against the risk of default. We still have room to add more credit risk should spreads go meaningfully wider, though we will continue to remove some if spreads tighten further.

Within active trades, the main focus so far this year has been the primary market, where we have been buying some bond issues which our analysts identify as retaining some decent spread premium over the secondary market. Early on, purchases were marginally skewed towards European financials, where there was a lot of new issuance in names our team of analysts worldwide were comfortable with. In this regard we continue to see fairly good relative value in financials versus wider corporates – but have also added to the latter in recent weeks.

A fund focus on capital preservation, maintained through…

- Structural **seniority** of debt held:

  62% senior unsecured
  28% secured
  7% subordinated
  3% cash (all as at 28.02.23)

- A low, **defensive duration** to help protect against rising interest rates

- Strong portfolio **diversification** by:
  - ✓ **Region** (exposures include UK, US, Europe, Canada)
  - ✓ **Sector** (eg Banks, Utilities, Autos, Insurance, Sovereign)
  - ✓ **Bond asset** class (ABS, investment grade credit, covered bonds, high yield)

Figure 3: Fund performance year to date (%) and five calendar years (% pa)

Past performance is not a guide to future performance

	YTD 2023	2022	2021	2020	2019	2018
M&G Short Dated Corporate Bond Fund I Inc	1.7	-2.1	0.2	3.2	4.7	-1.1
*Benchmark	1.3	-3.9	0.7	1.4	2.6	N/A

*Benchmark = The Markit iBoxx EUR Corporates 1-3 year Index (GBP Hedged) was introduced as the fund's benchmark on 13 March 2018. The benchmark is a target which the fund seeks to outperform. 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 fund manager has 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: Morningstar, as at 31 March 2023, Sterling Class I Inc shares, price to price, income reinvested. Benchmark returns stated in GBP terms.

M&G Investments

April 2023

- 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.
- 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 fund allows for the extensive use of derivatives.

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

The value of investments will fluctuate, which will cause fund prices to fall as well as rise and investors may not get back the original amount invested.

For financial advisers only. Not for onward distribution. No other persons should rely on any information contained within. This financial promotion is issued by M&G Securities Limited which is authorised and regulated by the Financial Conduct Authority in the UK and provides ISAs and other investment products. The company's registered office is 10 Fenchurch Avenue, London EC3M 5AG. Registered in England and Wales. Registered Number 90776.