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

Why Invest in High Yield FRNs today?

M&G Fixed Income team

February 2024

- Global high yield floating rate notes (FRNs) delivered strong returns in 2023, during a period of significant macroeconomic uncertainty. 2024 has begun in a very different vein, characterised by falling inflation, the prospect of monetary policy easing and cautious optimism that a soft landing may be achieved.
- We believe that this environment remains favourable for the HY FRN asset class. A combination of high all-in-yields, continuing inversion at the front end of sovereign yield curves, attractive spread levels, and relatively low default rates mean that HY FRNs are positioned to deliver solid returns in 2024, in our view.
- From a positioning perspective, we maintain our focus on the less cyclical parts of the market, and are particularly cautious on zero interest-rate model businesses, which may struggle in the next phase of the economic cycle.

The value of investments will fluctuate, which will cause prices to fall as well as rise. There is no guarantee the fund will achieve its objective, and you may not get back the original amount you invested. Where performance is mentioned, past performance is not a guide to future performance.

The case for HY FRNs

While the case for investing in floating rate notes in an environment of rising interest rates is obvious, there are a number of reasons why we believe HY FRNs continue to look attractive in today's environment. We highlight three of these below.

Firstly, many government yield curves remain inverted (yield curve inversion had originally taken place because short-term yields had risen much faster than longer-term ones, reflecting investor demand for shorter vs longer-term government bonds). FRNs are the best way to exploit this yield advantage on offer at the front end of sovereign yield curves. A carry trade involves borrowing at a lower interest rate in order to invest in instruments that pay a higher interest rate.

Secondly, spreads levels on HY FRNs continue to be higher than those of traditional high yield instruments. At the end of February, the option-adjusted-spread for global HY FRNs stood at 453bps on average, versus 350bps for the global high yield market (and even tighter for US HY). Technical factors are the main cause of this ongoing difference: specifically, supply and demand dynamics. While FRN supply has been stable, demand from collateralised loan obligation (CLO) structures and loan funds (typically important buyers of FRNs) has been lower. CLO issuance began to pick up in 2023 and if this trend continues as we expect, then we believe HY FRN spreads will likely tighten further, potentially translating into positive spread performance for the asset class.

Finally, markets are cautiously optimistic over the prospect of a soft landing as we enter the next phase of the economic cycle. While high yield corporate issuer fundamentals have held up reasonably well to date, we would expect to see an uptick in default rates as economies begin to slow. Our base case scenario remains that of a mild default cycle (this would result in a global default rate of c. 3-4%), which would be consistent with a soft landing. In our view, this would not be too damaging for the corporate sector. However, should default rates increase more aggressively, the fact that HY FRNs are typically categorised as senior-secured in the capital structure, with higher potential recoveries, can help mitigate capital downside.

As a result of the factors above, we believe that if the current macroeconomic environment persists, default rates remain low and credit spreads stable, the fund could deliver healthy returns over the next 12 months (see Figure 1 and Figure 2, overleaf).

Figure 1: Potential return scenarios: Fixed high yield vs floating high yield, USD hedged

Change in 3 months SOFR	Change in Credit Spreads (bps): -200	-150	-100	-50	No Change	50	100	150	200
-1.00%	9.5 15.7	9.0 14.0	8.5 12.3	8.0 10.6	7.4 9.0	6.8 7.3	6.2 5.6	5.7 4.0	5.2 2.3
-0.50%	10.0 14.0	9.5 12.3	9.0 10.7	8.5 9.0	7.9 7.3	7.4 5.6	6.9 4.0	6.4 2.3	5.8 0.6
No Change	10.5 12.3	10.0 10.7	9.5 9.0	9.0 7.3	8.4 5.7	7.9 4.0	7.4 2.3	6.9 0.7	6.3 -1.0
0.50%	11.0 10.7	10.5 9.0	10.0 7.3	9.5 5.7	8.9 4.0	8.4 2.3	7.9 0.7	7.4 -1.0	6.8 -2.7
1.00%	11.5 9.0	11.0 7.4	10.5 5.7	10.0 4.0	9.4 2.4	8.9 0.7	8.4 -1.0	7.9 -2.7	7.3 -4.3

ICE Bank of America Global Floating Rate High Yield 3% Constrained (USD Hedged) Index; ICE Bank of America Global Fixed High Yield Market Index Indicates where FRN market rate cushioning should outperform Global HY market. Source: M&G, ICE BoA, 29 February 2024.

Assumption of a 3% 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 to be affected by a 0% SOFR floor. A parallel shift in the yield curve is assumed. This is for illustrative purposes only and based on representative assumptions. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies, and/or current market conditions and are not an exact indicator.

Figure 2: Potential return scenarios: Fixed high yield vs floating high yield, EUR hedged

Change in 3 months EURIBOR	Change in Credit Spreads (bps): -200	-150	-100	-50	No Change	50	100	150	200
-1.00%	8.0 14.1	7.4 12.4	6.9 10.7	6.4 9.0	5.9 7.4	5.3 5.7	4.8 4.0	4.3 2.4	3.8 0.7
-0.50%	8.5 12.4	7.9 10.7	7.4 9.1	6.9 7.4	6.4 5.7	5.8 4.1	5.3 2.4	4.8 0.7	4.3 -1.0
No Change	9.0 10.7	8.4 9.1	7.9 7.4	7.4 5.7	6.9 4.1	6.3 2.4	5.8 0.7	5.3 -0.9	4.8 -2.6
0.50%	9.5 9.1	8.9 7.4	8.4 5.8	7.9 4.1	7.4 2.4	6.8 0.7	6.3 -0.9	5.8 -2.6	5.3 -4.3
1.00%	10.0 7.4	9.4 5.8	8.9 4.1	8.4 2.4	7.9 0.8	7.3 -0.9	6.8 -2.6	6.3 -4.3	5.8 -5.9

ICE Bank of America Global Floating Rate High Yield 3% Constrained (EUR Hedged) Index; ICE Bank of America Global Fixed High Yield Market Index Indicates where FRN market rate cushioning should outperform Global HY market. Source: M&G, ICE BoA, 29 February 2024.

Assumption of a 3% 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 to be affected by a 0% EURIBOR floor. A parallel shift in the yield curve is assumed. This is for illustrative purposes only and based on representative assumptions. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies, and/or current market conditions and are not an exact indicator.

Fund activity

The fund is positioned to seek to generate returns through a combination of carry, improving market technicals (which, in our view, should prove positive for spreads) and defensive active views.

From a sector perspective, we maintain our focus on more defensive and less cyclical parts of the market, such as food producers and distributors, and software and/or online education businesses.

Conversely, we are particularly cautious on zero interest-rate model businesses, which may struggle going forward. For example, we have no exposure to unsecured debt in the commercial real estate sector, where rental yields are currently below the cost of debt for many of these companies. Banking is another area of caution for us – HY-rated banks face greater fundamental challenges than their investment grade-rated peers. Finally, we have no exposure to debt purchasing businesses: with a business model that relies on zero interest rate funding, debt refinancing may be challenging for some issuers.

As we move into the next phase of the economic cycle, fundamental credit research will prove critical to capital preservation. In our view, our highly experienced team of fund managers and credit analysts are well placed to demonstrate the value that active management can deliver in such an environment.

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

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.

Past performance is not a guide to future performance.

Fund performance

Return (%)	Year to latest quarter	YTD	1 Yr pa	3 Yrs pa	5 Yrs pa	10 Yrs PA
Fund EUR A-H Acc	11.4	1.9	9.4	4.2	3.0	N/A
Benchmark (EUR)*	13.5	2.0	11.2	5.9	5.1	N/A
Fund USD A Acc	13.7	2.2	11.5	6.1	5.1	N/A
Benchmark (USD)*	15.8	2.2	13.3	7.8	7.1	N/A

Return (% pa)	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Fund EUR A-H Acc	N/A	-0.4	6.5	1.6	-2.6	4.3	-0.8	4.5	-3.3	11.4
Benchmark (EUR)*	2.1	-0.7	11.1	2.7	-1.3	6.8	2.0	6.6	-2.2	13.5
Fund USD A Acc	N/A	0.1	7.8	3.7	0.2	7.4	1.0	5.4	-1.1	13.7
Benchmark (USD)*	2.2	-0.2	12.7	4.8	1.5	10.0	3.6	7.4	0.0	15.8

*Benchmark: BofA Merrill Lynch Global Floating Rate High Yield Index (3% constrained) USD Hedged Index. For the EUR share class, 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. For the USD share class, benchmark prior to 01 April 2016 is the ICE BofAML Global Floating Rate High Yield (USD Hedged) Index. Thereafter, it is the ICE BofAML Global Floating Rate High Yield 3% Constrained (USD 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-authorised OEIC), which merged into this fund on 7 December 2018. Tax rates and charges may differ.

Source: Morningstar, Inc and M&G, as at 29 February 2024. Returns are calculated on a price-to-price basis with income reinvested. Benchmark returns stated in EUR and USD terms respectively.

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.