M&G (Lux) Emerging Markets Corporate ESG Bond Fund

Investment Review

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August 2021

- Sitting among M&G's flagship emerging market debt strategies (combined assets under management of $5 billion), the M&G (Lux) Emerging Markets Corporate ESG Bond Fund gives investors access to the fast-growing emerging markets corporate bond space.
- Utilising a bottom-up approach to capture our best investment ideas, the fund also applies a responsible investment screen and a special focus on environmental, social and governance (ESG) factors.
- With only a limited number of funds operating in the emerging markets corporate bond space with a robust ESG framework in place, we think the fund offers ESG-conscious investors a distinctive investment proposition in a fast-moving asset class.

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. Where any performance is mentioned, please note that past performance is not a guide to future performance.

Opportunities in the EM corporate debt space

Having been a fledgling area of the market for so long, the EM corporate bond space has grown to become a standalone asset class in its own right, and one that can demonstrate superior risk adjusted returns over time.[1] The EM hard-currency corporate bond market (including quasi-sovereign bonds) is now worth US$2.6 trillion[2], having been worth just US$600 billion a decade ago. This expansion has been driven by a period of strong economic growth among many developing economies in the years prior to the COVID-19 crisis, combined with record low interest rates over the past decade.

Besides offering a comparatively higher yield than many mainstream fixed income assets classes, EM corporate bonds denominated in hard currencies (mainly US dollars) also offer a breadth of diversification opportunities. The investment universe now stretches to more than 800 issuers and 2,000 bond instruments, across 52 countries (30 July 2021), with new issuance continuing to grow rapidly.[3]

Despite the shock to the global economy in the past 18 months, EM companies currently offer relatively healthy credit metrics, in our view. We think this is something that should appeal to investors worried about the potential for EM bond market volatility and interest rate sensitivity. Recent analysis has shown that net leverage among EM companies deteriorated only slightly during 2020[4] (Figure 1) and is still significantly lower than that of developed market companies.

Furthermore, among higher-yielding EM corporate bonds, the coverage ratio (a measure of how easily a company can pay interest on its outstanding debt) is now higher than that of their high yield peers in the US for the first time since 2013.[5] Against this backdrop, we expect relatively low default rates (approximately 2% to 3%) in the high yield segment of the EM corporate bond market in 2021.

Recently, a backdrop of higher US yields and growing inflationary pressure has acted as a drag on most fixed income instruments on a year-to-date basis. While the hard currency nature of much of the EM corporate debt universe has exposed the asset class to some sensitivity towards interest rate changes, its shorter duration profile has meant that investment returns have been more resilient compared to EM sovereign debt and other areas of fixed income (JPM CEMBI Index vs JPM EMBI Index).

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. Investing in emerging markets involves a greater risk of loss due to greater political, tax, economic, foreign exchange, liquidity and regulatory risks, among

[1] JP Morgan's EM Corporate 2021 Midyear Outlook, p40.

[2] Market sizes correct as at 31 December 2020. Source: JP Morgan.

[3] JP Morgan Emerging Market Bond Index (EMBI), Corporate Emerging Markets Bond Index (CEMBI), as at 30 July 2021.

[4] According to JP Morgan's EM Corporate 2021 Midyear Outlook.

[5] Ibid, p95.

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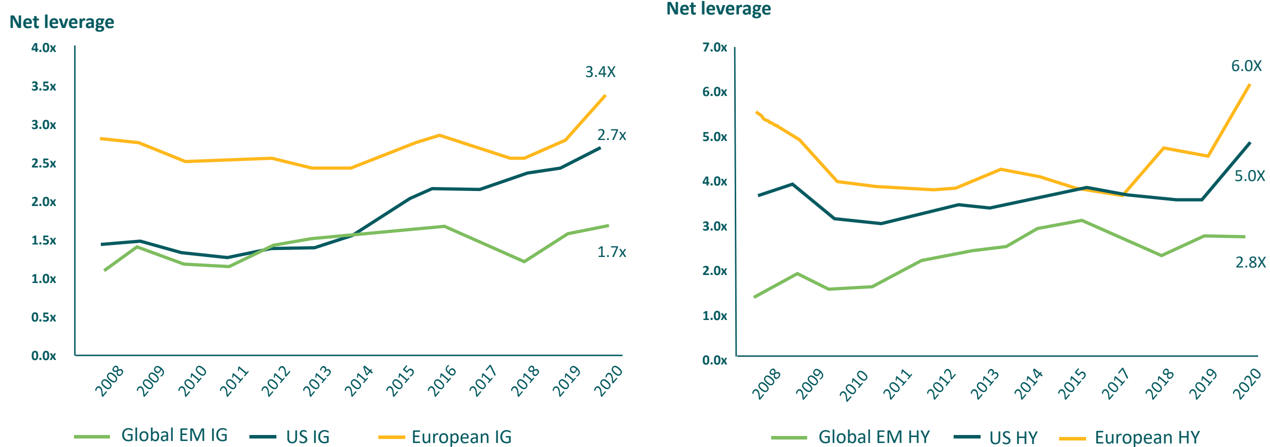
Figure 1. EM indebtedness still lower than DM



Source: JP Morgan, Bloomberg, Capital IQ

other factors. There may be difficulties in buying, selling, safekeeping or valuing investments in such countries.

Why M&G's approach now?

As credit spreads have tightened globally, we think the need for an actively managed approach towards the asset class is more important than ever. Investing in EM corporate debt, in our view, can offer investors attractive yields, a further layer of portfolio diversity and the opportunity to receive returns (yield and capital gain) potentially less correlated to the drivers of performance for sovereign bonds. These, we believe, are increasingly attractive features in a world with stubbornly low yields, provided default risk and credit risk are managed correctly.

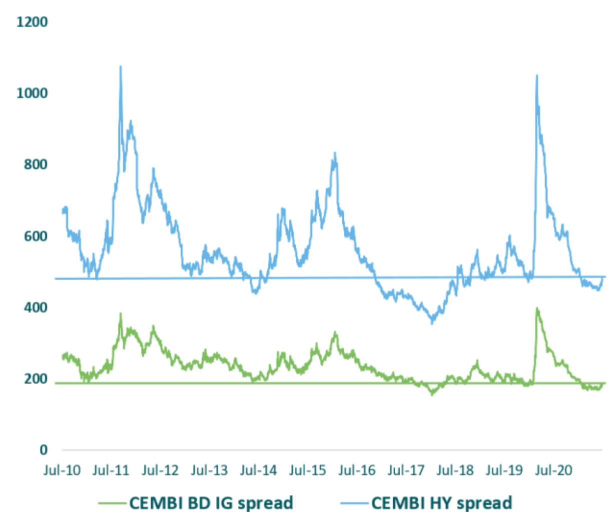
The fund currently favours exposure to higher-yielding issuers, as we believe credit spreads in that segment of the market should continue to be supported by the global economic recovery and compensate well for the relatively benign default risk environment (see Figure 2). The high yield segment also offers lower US dollar interest rate sensitivity than the investment grade cohort where credit spreads look fairly priced.

The fund can be exposed to different currencies. Movements in currency exchange rates may adversely affect the value of your investment.

The fund takes an active, high-conviction approach that combines our long-running experience of investing in emerging market bonds with sufficient levels of portfolio diversification and thorough risk management:

1. **Active Management**: The team uses a combination of bottom-up issuer selection based on company fundamentals combined with top-down analysis of macroeconomic factors. This investment approach leads to a portfolio of 'best ideas' that we believe should help the fund to navigate different market conditions.
2. **Diversification**: The team takes a flexible approach to the asset class, meaning we are not constrained by our benchmark and can invest anywhere in emerging market corporate debt, provided issuers meet our ESG investment criteria. We aim to build diversified portfolios.
3. **Risk Management**: the Emerging Markets Debt (EMD) team together with the risk team perform continuous risk management throughout the investment process, using quantitative modelling and analysis to identify and monitor key risk factor

Figure 2. More room to tighten in high yield



Source: JP Morgan, Bloomberg, Capital IQ

Past performance is not a guide to future performance

positioning and risk sensitivities including value at risk (VaR), stress tests and scenario analysis.

ESG integration in emerging market credit

Opaque ownership structures, poor governance standards and a lack of environmental consideration can make emerging markets uneasy hunting grounds for many investors. Furthermore, levels of transparency can vary significantly, making accurate and reliable information harder to source. However, these obstacles throw up opportunities for ESG-orientated active managers, making the work of credit research analysts and dedicated ESG teams much more valuable.

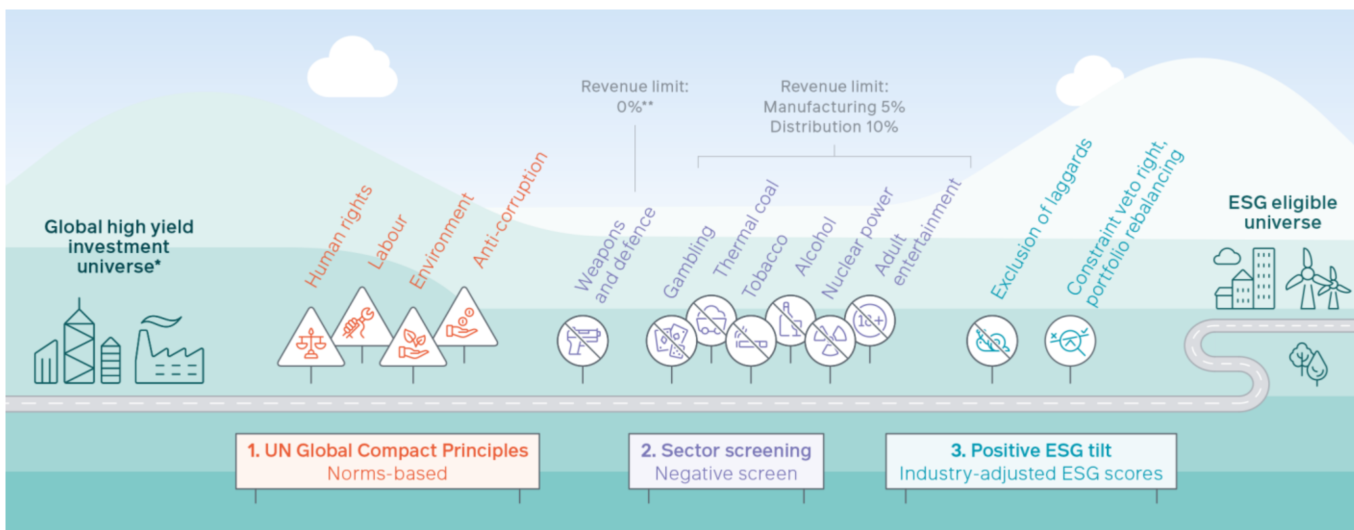
Our ESG philosophy is three-fold:

ESG matters for returns: We believe ESG integration supports both better risk management and alpha generation. We regard ESG-related factors as a critical consideration when assessing the creditworthiness of a corporate issuer in emerging markets. A thorough ESG analysis can help flag companies whose ESG shortcomings may ultimately lead to a deterioration in their credit profile. Conversely, ESG analysis can help us to identify potential outperformers in a way that traditional credit analysis may fail to capture. We assess corporate issuers using traditional credit analysis and according to their ESG merits, drawing on both internal and external ESG research. We are aided in this process by several ESG tools, including M&G's proprietary 'ESG Scorecard' – a system that quantifies a variety of ESG factors and indicates whether they are materially contributing or detracting from an analyst's credit rating. As opposed to many third-party ESG data providers who base their methodology on data processing and algorithms, we choose a more nuanced approach because we think that ESG is a largely qualitative domain. Hence, the M&G ESG Scorecard emphasises the qualitative aspects of ESG risks while producing a forward-looking and timely output.

Responsible investment: We are Responsible Investors and we care about both returns and outcomes of our investments. We use norms-based screening (UNGC)[6] as well as sector screening to ensure investment holdings are aligned with our philosophy of the fund at all times. In order to identify securities that meet the fund's ESG criteria, potential investments undergo a three-stage screening process (see Figure 3) to exclude certain types of organisations.

Participate in change: We aim to be market leaders in EMD corporate ESG investments through active ESG engagement and innovation. The fund was one of the first EM corporate ESG bond funds to be launched in the European market and we are continuously looking to improve our ESG credentials, improving our sustainable investment process and engaging with EM corporate bond issuers. Engagement is at the heart of the process, from credit research to investment decisions. We do not limit engagement to issuers with good ESG credentials, and have a strong and demonstrable track record in

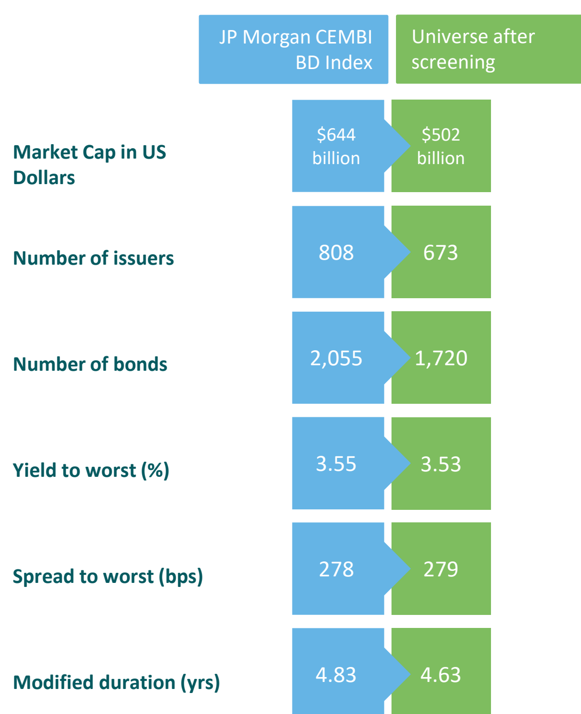
Figure 3. Three-stage screening process



Source: M&G * JPM CEMBI Broad Diversified Index ** On a best-efforts basis subject to our data providers

[6] UNGC - United Nations Global Compact principles

Figure 4. Universe after screening



Source: M&G, Bloomberg, JP Morgan indices. 30 June 2021

engaging with EM bond issuers in various sectors and across the credit quality spectrum.

Applying our process does not mean portfolio attributes are significantly impacted. EM corporates are one of the highest yielding asset classes and applying an ESG lens does not mean greatly sacrificing yield or universe size (see Figure 4).

Investment outlook

Overall, we believe the outlook for EM corporate debt remains positive against a backdrop of global economic recovery, strong and resilient corporate fundamentals and a diverse opportunity set offered by the asset class. We believe the risks of a potential 'taper tantrum' are lower than in 2013, which was when emerging market debt and currencies sold off sharply in response to US monetary policy tightening. This is because, in our view, many EM countries have fewer external vulnerabilities than eight years ago, particularly with regards to current account deficits. Should US rates rise faster than expected, we believe the shorter duration profile of corporate EM bonds is likely to make this one of the most resilient asset classes within emerging markets.

Furthermore, we think the health of many emerging market countries and companies should receive a significant boost in the second half of the year and into 2022 as COVID-19 vaccines become more readily available and demand for international tourism and commodities continues to rebound. Of course, investors should bear in mind the risk of further mutations of the coronavirus, more infections but also potentially able to evade existing vaccines, about which some scientists have warned. Uncertainty is still very high.

While we expect a modest amount of spread tightening from here, we must acknowledge that as the recovery has taken hold, EM corporate credit valuations have risen significantly from their lows of last year. For this reason we have been selectively de-risking parts of the fund, favouring BB rated high yield issuers and taking profits from positions in lower-rated single B issuers.

From a broader perspective, we believe EMs will continue to play a crucial role in driving the global economic recovery, which should enable corporate fundamentals to continue to improve. By carefully assessing the macro environment in combination with a detailed bottom-up approach to credit analysis, we believe we will be well-placed to navigate the potential opportunities and risks for EM debt issuers in the period ahead.

The fund allows for the extensive use of derivatives

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