M&G Sustainable European Credit Investment Fund

Optimising sustainability while applying a value-based approach

Gaurav Chatley, Fund Manager
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- Combining M&G's long-running expertise in fixed income investing with in-depth environmental, social and governance (ESG) analysis, the M&G Sustainable European Credit Investment Fund is designed to offer clients a core sustainable bond proposition which utilises our well-established research-driven investment approach.
- The fund applies a three-stage sustainable investment screening process, combined with an active approach to ESG investing based on in-depth research and company engagement.
- By maximising sustainability elements while applying a value-based approach, we believe the fund strikes the right balance between achieving a favourable ESG outcome along with the potential to deliver attractive investment returns.

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.

Overview

The M&G Sustainable European Credit Investment Fund is designed to offer clients a core sustainable bond proposition. The fund combines M&G's long-running expertise in European credit investing with an assessment of ESG factors. The fund draws on the M&G fixed income team's well-established, value-driven investment approach, which is backed by significant credit research resources and well-connected trading capabilities.

The fund's investment philosophy and investment guidelines are based on the M&G European Credit Investment Fund, which has been managed by fund manager Gaurav Chatley and the Institutional Public Debt Team since its inception in 2011. At the heart of the investment strategy is a bottom-up, research-driven and value-based approach to individual credit selection. We aim to capture risk premia through credit cycles, investing only where we have a strong conviction that a bond's price more than compensates for its associated risks. All non-base currency risks are expected to be hedged back to the base currency of the fund, which is euros. Furthermore, it is expected that the overall duration of the fund will be managed in line with its benchmark without significant deviation.

The M&G Sustainable European Credit Investment Fund puts sustainability factors at the core of its investment approach, with the aim of continuously maximising sustainability elements in the portfolio while maintaining a value-based investment approach. This results in a dual-target approach, combining a financial return objective with a commitment to run the portfolio in line with measurable Sustainability Indicators seeking to achieve a sustainable outcome while ensuring that environmental and social safeguards are in place.

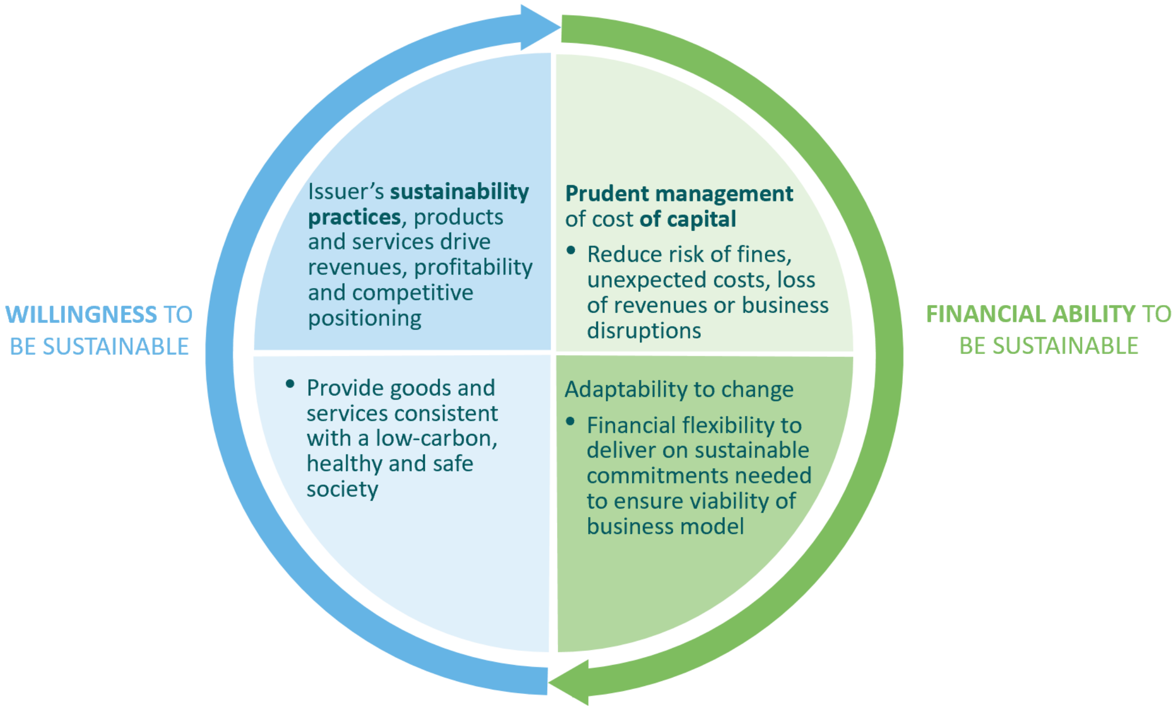
The fund seeks to outperform the Bloomberg MSCI Euro Corporate ESG BB+ Sustainable SRI Bond Index by +0.75% p.a. (gross of fees) over any five-year period, while applying ESG Criteria and Sustainability Criteria.

Defining sustainable investments

To be considered a sustainable investment, we believe businesses need to demonstrate both a willingness to embrace sustainability and the financial ability to deliver on those commitments. The fund screens bond issuers to identify companies whose sustainability practices drive its capital allocation decisions, with a focus on companies that provide goods and services consistent with creating a low-carbon, healthy and safe society.

However, we only consider a company as being a sustainable investment where its business model is backed by sound financials. Companies need to demonstrate an appropriate level of financial flexibility in order to achieve their sustainable commitments and to ensure the viability of the business over the long term. This includes the prudent management of its cost of capital and the careful management of financially-material ESG risks to reduce the likelihood of fines, unexpected costs, loss of revenues or business disruption.

Figure 1. Defining sustainable investments – sustainable businesses need sustainable finances



Source: M&G

Sustainable investment screening

In order to identify securities that meet the fund's sustainability criteria, potential investments undergo a three-stage process. The result is a sustainability themed investment universe, creating the opportunity set for the M&G Sustainable European Credit Investment Fund.

Assuring environmental and social safeguards

The first two stages seek to assure environmental and social safeguards by excluding companies or countries engaged in harmful or unsustainable activities.

Stage 1 - the fund excludes companies that are assessed to be in breach of the United Nations Global Compact principles on human rights, labour, environment protection and anti-corruption. This stage also excludes government bonds from countries classed as "Not Free" by the Freedom House index based on civil liberties and political rights.

Stage 2 - the fund seeks to exclude companies which are engaged in business activities deemed to be damaging to the environment and/or the wellbeing of society. We seek to filter out companies that derive a material part of their revenues from the following activities, which can be grouped according to the relevant exclusion criteria. Please note that for controversial weapons we apply stricter criteria and seek to exclude companies that derive any revenue from this activity.

Figure 2. Excluded business activities

Exclusion criteria	Excluded activities*
Social	Tobacco, alcohol, adult entertainment, gambling, conventional weapons, controversial weapons
Environmental	Thermal coal, oil & gas, nuclear energy and genetically modified crops

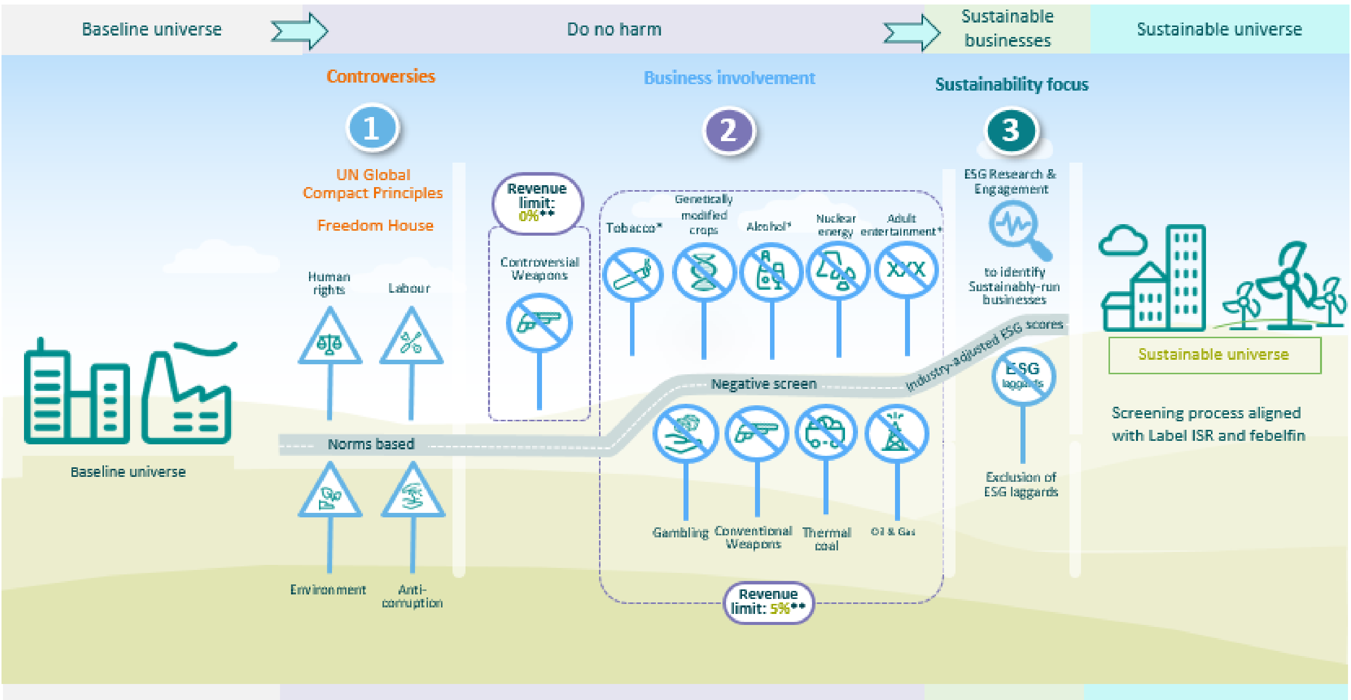
* Thresholds may apply

Source: M&G

Identification of sustainable businesses and exclusion of ESG laggards

Stage 3 – to ensure minimum quality standards in how financially-material ESG risks are managed, the fund seeks to exclude issuers considered to be ESG laggards based on the analysis of external research providers and M&G's in-house assessment.

Figure 3. Sustainable investment screen



Source: M&G, 2021, *Revenue threshold for retail distribution at 10%, **based on data from external specialist data providers

Actively driving sustainability in fixed income

Once the sustainability-themed universe has been defined through the three-stage screening process outlined above, the fund manager seeks to achieve a positive ESG tilt through the inclusion of issuers which display more favourable ESG characteristics, subject to relative value considerations.

The fund takes an active approach to ESG investing, based on in-depth ESG research and company engagement. We consider ESG analysis to be a vital complement to more traditional credit research, as it allows us to gain a more comprehensive picture of the investment case, while ensuring a more systematic assessment of the risk/reward metrics of a particular fixed income security.

The fund manager has access to a range of external ESG data providers, which ensures that the investment team have sufficient ESG data and research when undertaking their analysis. This is complemented by a range of proprietary tools to help optimise the fund's sustainability credentials.

Below we outline some of the key elements in our ESG analysis process to ensure the optimisation of the fund's sustainably credentials.

M&G ESG Scorecard – a proprietary tool that quantifies a variety of ESG factors for individual companies, and indicates the extent to which they are 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 favour a more nuanced approach as we believe that ESG is a largely qualitative domain. The M&G ESG Scorecard therefore emphasises the qualitative aspects of ESG risks while aiming for a granular, forward-looking and timely output.

Climate Transition Leaders - the climate section from the M&G ESG Scorecard is used to identify climate transition leaders. We look at climate intent and disclosure and assess if companies can evidence a net zero transition via science-based targets. We believe that identifying climate transition leaders can help us to make better investment decisions by mitigating climate-related risks.

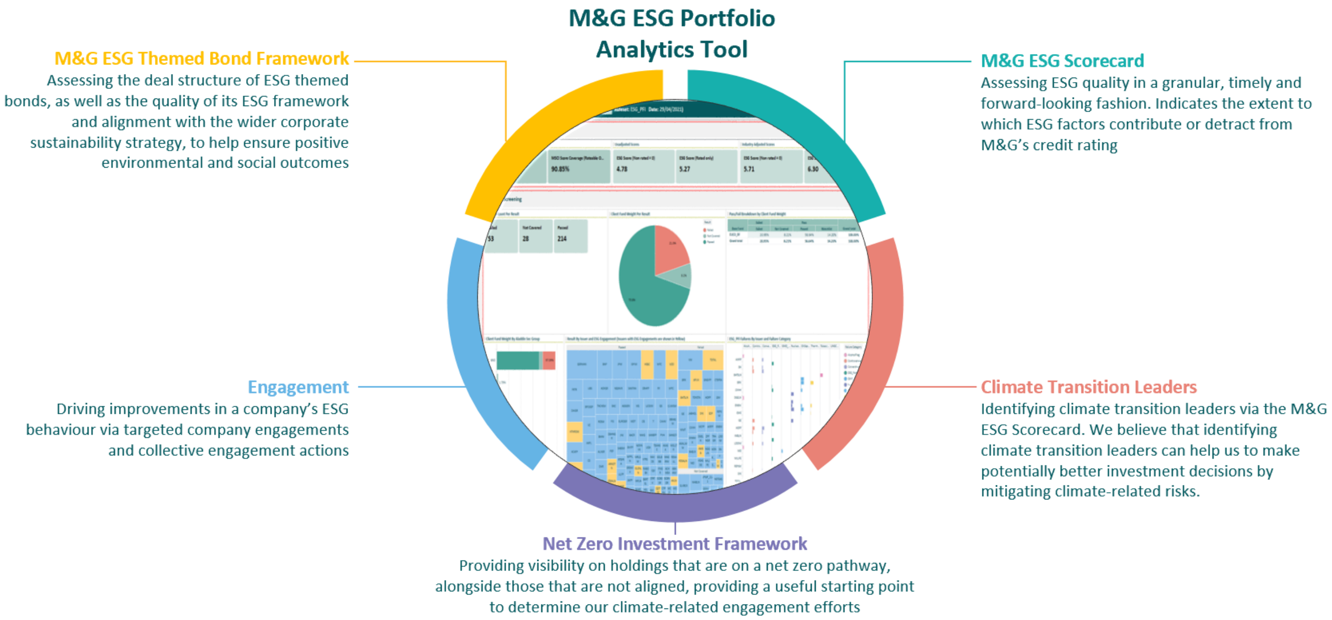
M&G Net Zero Investment Framework - a portfolio screening tool that allows fund managers to better assess the climate risk of their portfolio through a forward-looking lens. The tool provides visibility on holdings that are on a net zero pathway, alongside those that are not aligned, thereby providing a useful starting point to determining our climate-related engagement efforts.

Engagement – company engagement forms a key part of the fund's investment approach. As well as helping us to gain a better understanding of a company's ESG characteristics and risks, the engagement process can also help to drive improvements in a company's ESG behaviour and performance. M&G's significant scale in fixed income markets, and the need for companies to maintain good relationships with their lenders, means that we are often able to gain valuable access to an issuer's senior management. As well as engaging with companies on an independent basis, M&G utilises collective engagement alongside other lenders when this is expected to achieve a more fruitful outcome.

M&G ESG-Themed Bond Framework - subject to valuations, the fund manager will look for opportunities to expand the fund's allocation to ESG-themed bonds, such as green bonds, social bonds, transition bonds, sustainability bonds or sustainability-linked bonds. Within this framework we assess a bond's deal structure, as well as the quality of its ESG framework and its alignment with a company's wider corporate sustainability strategy to help ensure positive environmental and social outcomes.

ESG Portfolio Analytics Tool - a core portfolio analysis tool, which consolidates all the above ESG data into a single system. This allows the fund manager to slice and dice their portfolio using both external and proprietary ESG information, from which they can assess a range of information, such as portfolio ESG scores, enhanced climate information and the details on the companies we are engaging with.

Figure 4. Optimising sustainability credentials



The M&G ESG Portfolio Analytics tool is our core ESG portfolio analysis tool which consolidates all ESG research into a single system

Source: M&G, 2021.

Sustainability Indicators

We continuously monitor a range of Sustainability Indicators to ensure that all our investments are compatible with our definition of a sustainable investment, and to ensure we can evidence enhanced sustainability outcomes at the portfolio level. The Sustainability Indicators that are currently monitored can be grouped into the following categories.

Avoidance of controversial issuers

The fund excludes companies and countries with severe controversies as defined by the UN Global Compact Principles and the Freedom House organisation.

- **Relevant Sustainability Indicator**: no exposure to companies deemed to be in breach of the UN Global Compact Principles of human rights, labour, the environment and anti-corruption. 0% is determined as any issue with a "red" flag as determined by UNGC.
- **Relevant Sustainability Indicator:** no exposure to government bonds from countries considered "Not Free" by the Freedom House organisation

More sustainable, better run and less harmful businesses

The fund focuses on businesses which have superior ESG risk management practices and are less harmful to society and the environment. ESG laggards are deemed incompatible and excluded when initially defining this more sustainable universe. The fund also promotes the inclusion of issuers with better ESG characteristics where this is not detrimental to the pursuit of the investment objective.

- **Relevant Sustainability Indicator**: no exposure to business activities deemed to be harmful to society and the environment as outlined in Stage 2 of the sustainable investment screening process.
- **Relevant Sustainability Indicator:** no exposure to issuers considered to be ESG laggards based on the analysis of M&G's external research providers and M&G's in-house assessment.

Less harmful to the climate

The fund recognises the critical nature of climate change. Enabling lower carbon intensity economic activities is important now and in the future for the physical environment and for society as a whole.

- **Relevant Sustainability Indicator**: lower weighted average carbon intensity (WACI) (Scope 1+2 divided by US$ revenues) than the Euro Investment grade universe as represented by the ICE BofAML Euro Corporate Index.

A core sustainable bond proposition

Combining M&G's long-running expertise in fixed income investing with in-depth ESG analysis, the fund is designed to offer clients a core sustainable bond proposition which utilises our well established research-driven investment approach. By seeking to maximise sustainability elements while applying a value-based approach, we believe the fund strikes the right balance between achieving a favourable ESG outcome and seeking to deliver attractive investment returns.

Figure 5. Key fund facts

Fund name	Key Information
Launch date	7th October 2021
Fund Manager:	Gaurav Chatley
Base strategy:	M&G European Credit Investment Fund
Investment objective:	The fund seeks to return 0.75% gross of fees p.a. above its benchmark over any five-year period, while applying ESG Criteria and Sustainability Criteria.
Sustainability approach	The fund will not finance companies that do considerable harm to the environment or society, while a systematic focus is laid on issuers with adequate and sustainable ESG standards. The Fund invests in securities that meet the ESG Criteria and Sustainability Criteria.
Benchmark:	Bloomberg MSCI Euro Corporate BB+ Sustainable SRI Bond Index
Base currency:	EUR (hedged shareclasses available)
Fund structure:	Luxembourg SICAV - UCITS
Pricing/dealing frequency:	Daily

Source: M&G

Further information about the ESG assessment, scoring and investment process can be found in the ESG Criteria and Sustainability Criteria available on our website.

Risks associated with the fund:

Market risk: The value of investments and the income from them will rise and fall. This will cause the Sub-Fund price, as well as any income paid by the Sub-Fund, to fall as well as rise. There is no guarantee the Sub-Fund will achieve its objective, and you may not get back the amount you originally invested.

Credit Risk: The value of the Sub-Fund may fall if the issuer of a fixed income security held is unable to pay income payments or repay its debt (known as a default).

Interest Rate Risk: When interest rates rise, the value of the Sub-Fund is likely to fall.

Derivatives Risk: The Sub-Fund may use derivatives to gain exposure to investments and this may cause greater changes in the Sub-Fund's price and increase the risk of loss.

Counterparty Risk: Some transactions the Sub-Fund makes, such as placing cash on deposit, require the use of other financial institutions. If one of these institutions defaults on their obligations or becomes insolvent, the Sub-Fund may incur a loss.

Asset-Backed Securities Risk: The assets backing mortgage and asset-backed securities may be repaid earlier than required, resulting in a lower return.

Contingent Convertible Debt Securities Risk: investing in contingent convertible debt securities may adversely impact the Sub-Fund should specific trigger events occur and the Sub-Fund may be at increased risk of capital loss.

ESG Data Risk: ESG information from third-party data providers may be incomplete, inaccurate or unavailable. There is a risk that the investment manager may incorrectly assess a security or issuer, resulting in the incorrect inclusion or exclusion of a security in the portfolio of the Sub-Fund.

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Further details of the risks associated with the fund can be found in the fund's Prospectus.

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