Annual review and outlook

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

M&G Wholesale Public Fixed Income team

January 2022

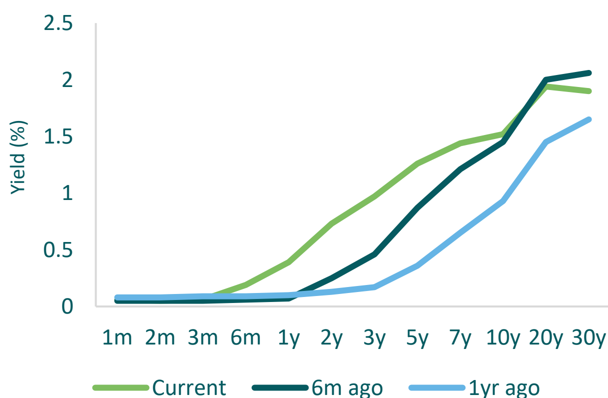
- High yield floating rate notes (HY FRNs) significantly outperformed many other bond markets in 2021, including fixed rate HY and investment grade credit.
- The macroeconomic environment also appears highly supportive for 2022, with HY FRNs' floating rate coupons offering the potential to mitigate the effects of expected interest rate rises this year. At the same time, the higher levels of income available on HY debt should offer an additional buffer against inflation.
- Strong economic and corporate fundamentals suggest a benign default outlook for HY markets, with the senior-secured status and low spread duration compared to fixed rate HY offering further layers of protection.

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.

HY FRNs were well-placed for 2021's inflationary environment

Inflation was the hot topic in 2021, as the easing of lockdowns, supply chain bottlenecks and the effects of ultra-loose monetary and fiscal policies combined to send consumer price rises to multi-decade highs. For most of the year, central banks maintained the narrative of 'transitory' inflation, but this stance was eventually softened, as the US Federal Reserve began to reduce its monthly asset purchases in November before announcing it would double the pace of tapering shortly after. By the end of the year, the market expected at least three interest rate rises in 2022, with few signs of inflation abating (see Figure 1).

Figure 1. Rising inflation brings interest rate rise expectations forward (US yield curve)

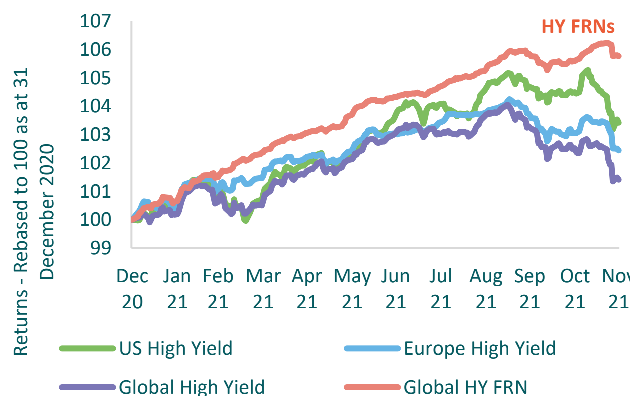


Past performance is not a guide to future performance.
Source: US Department of the Treasury, as at 31 Dec 2021.

At the same time, the ongoing global economic recovery led to improving corporate fundamentals, with government support measures for businesses and consumers in place for large parts of the year; more relaxed lockdown restrictions than 2020; and pent-up household savings all helping to create strong consumer demand. Many companies, including HY issuers, experienced EBITDA (earnings before interest, taxes, depreciation and amortisation – used as a measure of a company's overall financial performance) recoveries, deleveraging and a benign default environment as a result.

Against this backdrop, 2021 proved to be a bumper year for HY FRNs, as the asset class significantly outperformed fixed rate HY markets, as well as investment credit (see Figure 2).

Figure 2. HY FRNs have significantly outperformed fixed rate HY in 2021



Past performance is not a guide to future performance. **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. 30 Nov 2021

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.

Among the most supportive factors for the asset class was the growing expectations of tighter monetary policy, as investors sought floating rate debt to effectively remove interest rate risk. HY FRN coupons rise in line with a reference rate, for example EURIBOR, and typically reset every three months, which means their duration is close to zero.

With less fear of defaults and historically tight spreads in investment grade markets, the appeal of HY debt also grew, as investors looked for additional levels of income to protect the real value of their capital against inflation.

There were also several other tailwinds for HY FRNs in 2021, notably record levels of issuance from collateralised loan obligations (CLOs)[1], which are major buyers of HY FRNs, resulting in high levels of technical demand to fund merger and acquisition (M&A) activity. This led to a wider range of new issues in the HY FRN primary market compared to 2020, creating greater diversification and additional potential opportunities.

Despite a strong year overall, there were notable bouts of volatility, as waves of the pandemic and, later, the emergence of the new COVID-19 Omicron variant temporarily threatened to derail the economic recovery. In these instances, HY FRNs typically fared better than their fixed rate HY counterparts, given their additional defensive properties. These include intrinsically lower volatility, with a spread duration of around 1.6 years compared to 3.9 years[2] among their fixed rate counterparts, and senior-secured status, with over 80%[3] of the HY FRN market ranked as senior-secured, which puts investors first in line to recover debts in any potential default scenario.

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

Returns (%)	1 yr	3 yrs pa	5 yrs pa	Since inception pa*
Fund	4.46	2.63	1.37	1.63
Benchmark	6.55	5.11	3.32	3.40
Sector	2.74	4.74	2.61	2.46

Past performance is not a guide to future performance.

Sector is Morningstar Global High Yield Bond (EUR Hedged) Sector.**Share class inception date: 11 September 2014.This is the inception date of the UK-authorised OEIC.* Fund performance prior to 21 September 2018 is that of the equivalent UK-authorised OEIC, which merged into this fund on 7 December 2018. Tax rates and charges may differ.

Over 2021, the M&G (Lux) Global Floating Rate High Yield Fund delivered a strong positive return, albeit lower than its benchmark, due mainly to its more defensive positioning than the index.

Calendar-year performance, five years (%)

Returns (%)	2021	2020	2019	2018	2017
Fund	4.46	-0.75	4.25	-2.57	1.62
Benchmark	6.55	1.99	6.84	-1.30	2.73
Sector	2.74	2.47	9.31	-5.04	4.31

Past performance is not a guide to future performance.

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.

Source: Source: Morningstar, Inc., as at 31 December 2021, EUR Class A-Hedged Acc shares, price-to-price, income reinvested.

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.

[1] Source: Credit Suisse, Monthly CLO Issuance, September 2021.

[2] Source: Bloomberg, 1 November 2021.

[3] Source: M&G, ICE Bank of America Global Floating Rate High Yield (3% Constrained) Index, 31 December 2021.

Contributors

Among the positive contributors to performance was our decision to increase our allocation towards physical FRN bonds – as opposed to synthetic floating rate exposure via credit default swaps (CDS) – to the highest levels since the funds inception. This supported portfolio performance, as physical HY FRNs significantly outperformed fixed rate HY, the latter of which determines CDS performance.

Security selection was another positive driver of returns, with several bonds purchased at low cash prices in 2020, including natural gas pipeline services provider ETP; recycling company Groupe Ecore; and finance group AnaCap rallying back towards par value.

We also sought to take advantage of potential relative value opportunities, with a tilt within the services sector towards companies we believe will be more inflation-proof, such as supermarkets.

Meanwhile, the fund benefited from having no exposure to index constituent Carlson Wagonlit, a travel agent, which defaulted in 2021. We had closed our position in early 2020 due to concerns about the survival prospects for this type of company.

Detractors

Our more defensive positioning than the benchmark index led to us being underweight in some distressed names that rallied strongly in 2021, notably Spanish ferry operator Naviera Armas, to which we hold no exposure. We have maintained a negative view on the company, due to its weak cashflows, high capital expenditure, increasing leverage and vulnerability to potential future lockdowns.

Although we increased our allocation to physical FRNs, we maintain an exposure of around 10% of fund net asset value (NAV) to CDS via the North American high yield index. This position is designed to provide additional portfolio liquidity, given the liquid nature of CDS instruments, and diversification due to the additional breadth and depth of the broader HY market. In 2021, this delivered positive absolute returns, but detracted from returns relative to the benchmark index.

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.

Our real-estate positioning also cost performance overall. We were significantly underweight in Chinese developer Greenland due to our concerns about the business. However, the bond matured without incurring a default and dropped out of the index towards the end of the year. Meanwhile, we added a small (0.3% of NAV) off-benchmark position in Yuzhou, which we felt had been unduly punished. However, despite being a relatively strong player in the sector, the bond suffered contagion from growing concerns around the sector towards the end of the year, which led to it becoming the portfolio's biggest underachiever.

Portfolio activity

In terms of asset allocation, we maintained exposure of around 90% of NAV to physical FRNs during 2021. For context, this compares to less than 50% between 2016 and 2018, which highlights the extent of the potential opportunity we see in the asset class[4]. In our view, this remains the most attractive way to purchase floating rate risk in the current environment.

The portfolio also remained structurally underweight in cyclical sectors versus the benchmark index. While this cost relative performance in 2021, we believe it can provide additional layers of protection for HY investors, with these sectors remaining vulnerable to potential downside surprises in terms of economic growth and lockdowns.

The notable increase in primary market issuance last year compared to 2020, as well as strong client inflows to the fund, meant we were active market participants in 2021.

We were active in the first half of the year, particularly the second quarter, purchasing Oriflame, a Swedish cosmetics company; Pfleiderer, a German building materials company; Golden Goose, an Italian luxury footwear company; David Lloyd (a UK gym operator), Transcom, (Scandinavian call centres); and Picard Group (French supermarkets). At the same time, we reduced some existing, former investment grade holdings, AIG and General Electric. Similarly, we reduced the overall exposure to Selecta and trimmed the holding of Newday.

The second half of the year was also busy. We were active in both primary and secondary markets, the former seeing us participate in new issues from Picard; Parts Europe in the auto industry; and APCOA, the car park management company. In secondary markets, we topped up several high-conviction names, including Arrow Global, a finance company; Multiversity, an Italian education provider; and TK Elevators.

[4] Source: M&G. 30 November 2021. Data prior to 7 December 2018 is for the M&G Global Floating Rate High Yield Fund, a UK registered OEIC. Since then, data referenced is for the M&G (Lux) Global Floating Rate High Yield Fund, a Luxembourg registered SICAV.

Overall, we continue to favour issuers that are more ‘asset heavy’, given the better potential for recovery that these bonds typically offer in default scenarios, with over 80% of the portfolio comprising senior-secured debt.

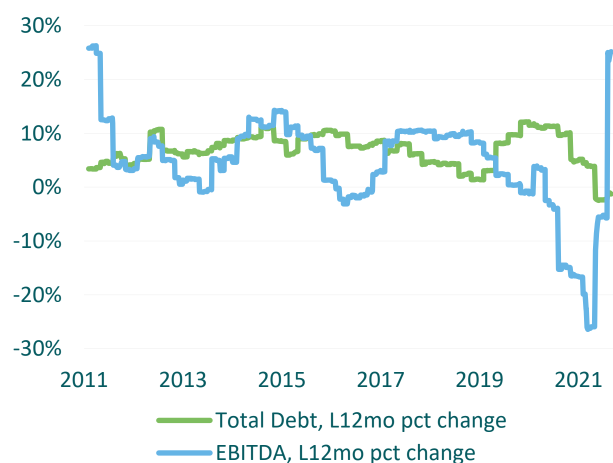
Outlook

In our view, floating rate assets are well-positioned to navigate the investment environment of 2022, with central banks sending strong signals that monetary policy will become significantly tighter, which we would expect to support assets that mitigate interest rate risk, such as HY FRNs.

In early January, several large investment banks forecast that the US Federal Reserve will make four interest rate hikes over the coming year, up from the three that were forecast just a month earlier. In Europe, the European Central Bank (ECB) has announced that it will end net asset purchases under its Pandemic Emergency Purchase Programme (PEPP) in March 2022[5]. Although the ECB maintains for now that it will not raise rates until 2023, many expect these rate hikes to be brought forward. Meanwhile, in the UK, the Bank of England has already begun to raise interest rates, following a surprise move in December.

The default outlook also continues to look benign, which we believe will be supportive of HY debt, particularly given the lack of yield available on investment grade credit. In the third quarter of 2021, corporate earnings surprised to the upside, with companies seemingly able to pass on higher costs to consumers. Company earnings are now significantly higher while total debt is lower (see Figure 4).

Figure 4. US HY total debt and EBITDA (12m % change)



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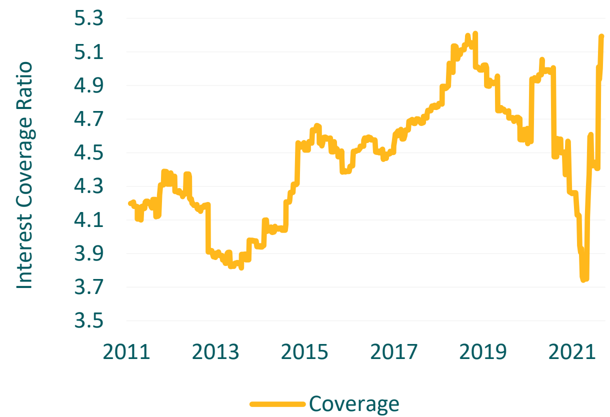
Source: ICE Bank of America HY Global Credit chartbook, September 2021. Universe represented by ICE BofA US High Yield Index.

This puts companies in a much stronger position to make interest payments, as shown by significantly improved interest coverage ratios (see Figure 5).

Figure 5. US HY interest coverage



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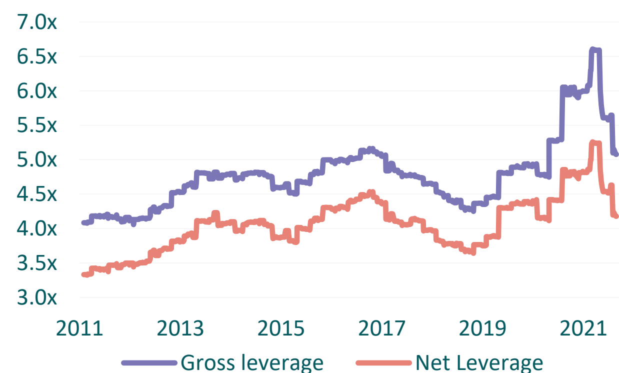
Source: ICE Bank of America HY Global Credit chartbook, September 2021. Universe represented by ICE BofA US High Yield Index.

And overall leverage is lower (see Figure 6), which means that companies face lower overall debt burdens, which we would expect to reduce the chances of defaults and improve prospects for recoveries for senior-secured debt, such as HY FRNs.

Figure 6. US HY gross and net leverage



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Source: ICE Bank of America HY Global Credit chartbook, September 2021. Universe represented by ICE BofA US High Yield Index.

With inflation continuing to rise, we believe HY income can offer a greater potential to earn positive real yields and protect the real value of investors’ capital. At the same time, HY FRNs have a potential advantage over fixed rate HY in their ability to effectively remove interest rate

[5] European Central Bank, Press Release: Monetary policy decisions, 16 Dec 2021

risk and offer potentially higher levels of protection, including senior-secured ranking in the capital structure and lower intrinsic volatility through their lower spread duration.

In our view, the M&G (Lux) Global Floating Rate High Yield Fund is well-placed to deliver these potential advantages, given M&G's extensive resources in this area, with one of Europe's largest in-house credit research teams and over €200bn of fixed income assets under management (AUM)[6], alongside a strong track record in managing HY FRN portfolios since 2014, with over €2bn AUM in the strategy today[7].

M&G Wholesale Public Fixed Income team
January 2022

The fund allows for the extensive use of derivatives.

[6] Source: M&G, 30 June 2021

[7] Source: M&G, 31 December 2021

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