Potential opportunities in high yield floating rate bonds

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

M&G Wholesale Public Fixed Income team
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- Low duration, high income strategies can offer potential protection in today's low yield, reflationary environment.
- High yield floating rate notes (HY FRNs) currently provide a potential relative value opportunity versus conventional HY bonds, due to their minimal interest rate risk, lower intrinsic volatility and greater capital upside potential.
- The M&G (Lux) Global Floating Rate High Yield Fund is designed to provide a defensive and liquid approach to HY investing.

The value and income from the funds' 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 funds will achieve their objectives and you may get back less than you originally invested.

Investors seek lower duration and higher potential income

Having lagged investment grade (IG) credit returns in 2020, HY corporate bonds have recovered strongly this year, as some investors have sought to reduce duration and increase income potential within their portfolios.

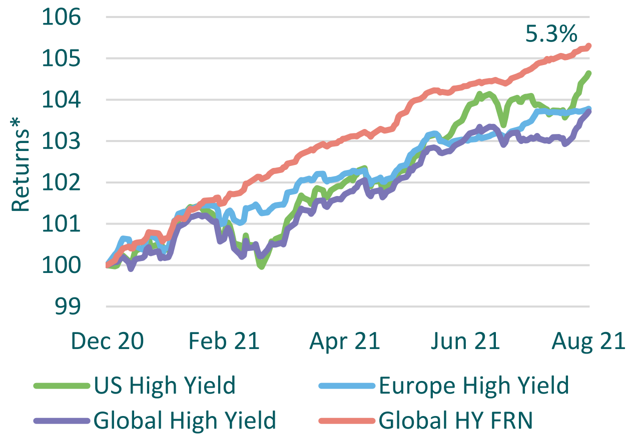
The benign default outlook for many sectors, combined with improving HY company fundamentals and growing expectations that central banks will soon tighten monetary policy, means that HY bonds could continue to offer a potentially attractive way for investors to protect their portfolios from rising interest rate and inflation risks.

In particular, HY FRNs could play an important role in portfolio diversification, with the asset class having materially outperformed other areas of HY bond markets in the year to date (YTD), as shown in Figure 1, delivering a 5.3% YTD return.

In this short note, we explore what we believe are four main drivers behind the potential opportunity in HY FRNs and offer an insight into how we aim to navigate the coming period in managing the M&G (Lux) Global Floating Rate High Yield Fund.

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. High yield bonds usually carry greater risk that the bond issuers may not be able to pay interest or return the capital.

Figure 1. HY FRNs outperform fixed rate HY, 2021 YTD



**Returns rebased to 100 as at 31 December 2020.*

Source: ICE Bank of America Indices, 31 August 2021. Information is subject to change and is not a guarantee of future results.

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.

Past performance is not a guide to future performance.

1. Lower interest rate risk

The US Federal Reserve has signalled that it will begin to taper asset purchases by the end of this year. As the expected recovery continues, the Bank of England and the European Central Bank may soon follow. If so, the potential rise in sovereign bond yields is likely to have a knock-on effect on the value of other fixed rate bonds. While HY corporate bonds typically have lower interest rate sensitivity (duration) than their IG credit and sovereign counterparts, the average duration of the *ICE BofA Global High Yield Index* is still significant, at 3.9 years[1]. Should interest rates rise in coming months, there could be a slightly higher impact on capital compared to HY FRNs, which typically have close to zero duration. This effectively insulates HY FRNs from the negative effects of rising interest rates and offer floating coupons, providing income that increases in line with interest rates.

2. Historically lower volatility during market stress

The HY FRN market beta is lower than for conventional HY bonds, with an average spread duration of 1.6 years compared to 3.9 years[2]. As a result, the HY FRNs will typically follow the same overall direction as the fixed rate HY market, but with lower volatility, particularly in times of market stress. This has been the case during various market episodes since the fund's inception, where HY FRNs have experienced a lower drawdown than the conventional HY bond market, including in periods of uncertainty around potential US tapering in 2015, the global inflation scare in 2018 and the recent COVID-19 crisis.

3. Capital upside potential

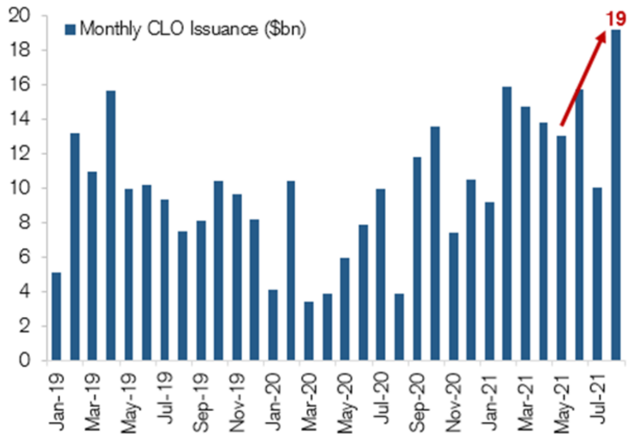
Most HY bonds have embedded call options, which enable the issuer to repurchase the bonds from bondholders at a specified date and price. With yields close to multi-year lows, and prices close to multi-year highs, the fixed rate HY bond market faces a considerable hurdle in terms of potential capital upside. Many of these bonds are now trading at or above their next call price – the threshold at which repricing is in-the-money.

Currently, around 67% of US HY bonds are trading above their next call price[3], whereas only 35% of the HY FRN market faces the same negative convexity constraint[4]. This implies further capital upside potential in HY FRNs in addition to the protection they provide against rising rates.

4. Technical factors support HY FRN demand

Collateralised loan obligations (CLOs) are a significant buyer of HY FRNs. The ongoing surge in mergers and acquisitions means that CLOs may continue to drive strong technical demand for HY FRNs in the coming period. Although CLO issuance dried up in 2020, which proved a headwind for HY FRNs, market supply has normalised and recent volumes set a record for the month of August[5] (see Figure 2).

Figure 2. CLO primary issuance ($ bn)



Source: Credit Suisse, September 2021

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

We originally launched our global HY FRN strategy in 2014, and today investors can access this through the M&G (Lux) Global Floating Rate High Yield Fund. In managing the fund, we look to apply a more defensive approach to investing in the asset class compared to the benchmark index, with historically lower concentrations in certain cyclical sectors with a view to reducing volatility. We have also looked to avoid some distressed index constituents in recent periods.

In this context, the fund has delivered strong long-term returns, with particularly robust performance over the past year (see performance tables below). Today, our focus remains on providing capital protection, minimal interest rate risk and daily liquidity. A large majority of the portfolio is invested in senior secured bonds, which can provide significant downside protection through higher potential recovery rates in default scenarios. The fund also offers daily dealing, which is not typically available for less liquid HY alternatives, such as leveraged loan funds. Currently, over 85% of the portfolio is invested in physical HY FRNs – as opposed to synthetic floating rate positions – due to the relative value opportunity we believe currently exists in the asset class.

We believe global HY FRNs represent an attractive potential opportunity for portfolio diversification, given the broader macro environment and our extensive capabilities in this area, with M&G being among the

[1] *Source: ICE BofA index, 28 Sep 2021*
[2] *Source: ICE BoA Global High Yield Index, ICE BofA Global High Yield Floating Rate Loan (3% Constrained) Index, 28 Sep 2021*
[3] *Source: S&P LCD, iBoxx, Bloomberg, Goldman Sachs Global Investment Research, accessed via Goldman Sachs Marquee Global Markets Daily, 14 Sep 2021*
[4] *Source: Bloomberg, M&G analysis, 28 Sep 2021*
[5] Source: Credit Suisse Credit Strategy Daily (Loan August Recap), 6 Sep 2021

leading active bond investors in Europe, with its $243 billion of fixed income funds under management[6] and one of the region's largest in-house credit research teams. In our view, the M&G (Lux) Global Floating Rate High Yield Fund remains well-positioned to capitalise on these potential opportunities for investors.

Fund performance, (%)

Returns (%)	YTD	1yr pa	3yrs pa	5yrs pa	Since inception pa*
Fund (EUR A-H)	3.85	9.94	1.41	1.78	1.63
Benchmark**	5.23	12.01	3.86	3.69	3.38
Sector	3.10	7.67	3.45	2.96	2.60

Returns (%)	2020	2019	2018	2017	2016
Fund (EUR A-H)	-0.75	4.25	-2.57	1.62	6.51
Benchmark**	1.99	6.84	-1.30	2.73	11.13
Sector	2.40	9.31	-5.08	4.29	9.89

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**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.

**Benchmark prior to 01 April 2016 is the ICE BofAML Global Floating Rate High Yield (Hedged) Index. Thereafter it is the ICE BofAML Global Floating Rate High Yield 3% Constrained (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 August 2021, EUR Class A-Hedged Acc shares, price-to-price, income reinvested.

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.

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

UCITS HAVE NO GUARANTEED RETURN, AND PAST PERFORMANCE IS NOT A GUIDE TO FUTURE PERFORMANCE

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